United States Court of Appeals

for the Second Circuit

BRIEF FOR APPELLEE

76-7278

IN THE

United States Court of Appeals

FOR THE SECOND CIRCUIT

No. 76-7278

MARGARET MARY McDONNELL MURPHY,

Plaintiff-Appellant,

—against—

McDONNELL & CO., INCORPORATED and THE NEW YORK STOCK EXCHANGE by ROBERT W. HAACK, President,

Defendants-Appellees,

JAMES F. McDONNELL, JR., individually, as Trustee under the Will of James F. McDonnell and as Executor of the Estate of Anna M. McDonnell, and CHARLES E. McDONNELL, as Executor of the Estate of Anna M. McDonnell,

Plaintiffs-Appellants.

—against—

THE NEW YORK STOCK EXCHANGE by ROBERT W. HAACK, THE NEW YORK STOCK EXCHANGE, INC., THE AMERICAN STOCK EXCHANGE by H. VERNON LEE, JR., Secretary, and McDONNELL & Co., INC.,

Defendants-Appellees.

On Appeal from the United States District Court For the Southern District of New York

BRIEF FOR DEFENDANT-APPELLEE NEW YORK STOCK EXCHANGE, INC.

MILBANK, TWEED, HADLEY & McCLOY
Attorneys for Defendant-Appellee New York Stock Exchange, Inc.
1 Chase Manhattan Plaza
New York, N. Y. 10005

Of Counsel:
RUSSELL E. BROOKS
TONI C. LICHSTEIN
WILLIAM C. OWENS, JR.

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BRIEF FOR DEFENDANT-APPELLEE NEW YORK STOCK EXCHANGE, INC.

Issues Presented for Review

The issues presented for review which relate to appellee New York Stock Exchange, Inc. (the "Exchange") are:

1. Did the trial court's charge properly describe the Exchange's net capital rule?

2. Did the trial court err in dismissing at the close of the evidence all disclosure claims asserted against the Exchange?

3. Did any of the following evidentiary rulings constitute an abuse of discretion which denied substantial justice to plaintiffs:

A. Admission of evidence describing the principle of self-regulation under the Securities Exchange Act of 1934 ("Exchange Act") and the application of that principle to McDonnell & Co., Incorporated ("McDonnell");

B. Exclusion of hearsay opinion evidence which generally commented on certain aspects of the Exchange's regulatory program but was created after the events and made no reference to the Exchange's regulation of McDonnell;

C. Exclusion of certain evidence which plaintiffs claim to be relevant to the reasonableness of the Exchange's regulation, but which was rejected on grounds of relevance, hearsay, or improper form of the question; and

D. Admission of evidence of the close familial relationship of plaintiffs and their relatives to the persons who owned and ran McDonnell and who negotiated plaintiffs' investments in that firm?

4. Did the trial court err in not granting plaintiffs' motions for a directed verdict and judgment notwithstanding the verdict against the Exchange?

5. Should the result below be affirmed on the ground that plaintiffs lack standing to sue under Section 6 of the Exchange Act?

Statement of the Case

This is an appeal from the judgment of the United States District Court for the Southern District of New York, Hon. Richard Owen, entered on May 13, 1976, dismissing all claims against the Exchange after eighteen days of trial before a jury.

In early 1969, McDonnell needed additional net capital to comply with the Exchange's net capital rule. T. Murray McDonnell, the president of the firm, requested his mother, plaintiff Anna M. McDonnell, and his sister, plaintiff Margaret Mary McDonnell Murphy, to make subordinated loans of securities to McDonnell. James F. McDonnell, Jr. was requested by his brother Morgan, a vice president and major shareholder in the firm, to purchase voting stock in McDonnell and to take over as the manager of McDonnell's Detroit branch office. A debenture issued by McDonnell in the principal amount of $318,622, which was owned by the trustees under the Will of James F. McDonnell, Sr., and matured on December 31, 1968 (the "Debenture"), was exchanged by T. Murray McDonnell, who was one of the three trustees, for a debenture maturing ten years later, thus continuing the Debenture as capital for McDonnell. In March, 1970, McDonnell was liquidated.

Mrs. Murphy filed her complaint on February 3, 1971. She alleged, in substance, that McDonnell had not told her the true financial and operational condition of the firm when she made her subordinated investment. She claimed that the Exchange was responsible for the fraud of McDonnell and, in addition, failed to regulate properly McDonnell

under Section 6 of the Exchange Act, 15 U.S.C. § 78f[1], causing Mrs. Murphy to lose her investment. By agreement, all fraud claims were tried under a Rule 10b-5 theory.

Plaintiffs Anna McDonnell and James F. McDonnell, Jr., individually and as trustees, filed their complaint on April 30, 1971. The claims of Anna McDonnell and James F. McDonnell, Jr., individually, paralleled those filed earlier by Mrs. Murphy against McDonnell and the Exchange. In addition, the trustees claimed that the exchange of the Debenture was fraudulently accomplished by McDonnell because Anna McDonnell and James F. McDonnell, Jr., as trustees, did not consent to the exchange. The Exchange was charged under Rule 10b-5 with aiding and abetting the unauthorized exchange of the Debenture. Additionally, a Section 6 claim was asserted by the trustees against the Exchange for the loss of value of the Debenture and 797 shares of stock of McDonnell owned by the trust under the Will of James F. McDonnell, Sr.[2] All claims against the Exchange were also pleaded against defendant American Stock Exchange, Inc. (the "Amex").

By order filed April 16, 1973, both actions were consolidated for all purposes.

On March 3, 1975, the Exchange filed a motion for summary judgment dismissing all Section 6 claims for lack of standing. (Vol.[3] 1, xvii) The Exchange argued that plaintiffs, as capital contributors, were not among the class of public customers whom Congress intended to benefit by enactment of Section 6. The court reserved decision on the motion. The Exchange renewed the motion at trial (Vol. 5, Tr. 1477-1478), but it was never decided. The Exchange

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[1] Unless otherwise designated, all references to the Exchange Act are to the Act prior to the amendments accomplished by the Securities Acts Amendments of 1975, P.L. No. 94-29, 89 Stat. 97 (June 4, 1975).

[2] No appeal is taken by James F. McDonnell, Jr., individually, or by the trustees in respect to the 797 shares of McDonnell stock.

[3] "Vol." refers to the designated volume of the Joint Appendix. "Tr." will refer to the trial transcript contained therein.

argues, *infra,* that plaintiffs' lack of standing is sufficient ground to affirm the result below.

Trial before a jury commenced on April 28, 1975. During eighteen trial days the jury heard the testimony of 17 witnesses, including two by deposition transcript. Approximately two hundred documents, some lengthy and complex, were admitted into evidence. At the close of plaintiffs' case, the Exchange moved for a directed verdict. The court reserved decision. The court granted the motion of the Amex, dismissing all claims against it.

On the motion of the Exchange for a directed verdict at the close of all the evidence, the court dismissed all Rule 10b-5 claims against the Exchange on the ground that no proof had been submitted to show that the Exchange had any knowledge of fraud by T. Murray McDonnell upon the plaintiffs or any reason to suspect such fraud. (Vol. 7, Tr. 2357-2358) The court said:

> "I am going to take out of the case the fraud claims based on 10(b)(5) insofar as they are asserted against the stock exchange.
>
> "I don't find any proof here—and, Mr. Beebe, hear me out on this, and if you can persuade me to the contrary I will be prepared to listen to you—I don't find any proof here that the exchange had any knowledge that Murray McDonnell's statements were being made, let alone were fraudulent.
>
> "I don't find any proof here that the exchange had any reason to suspect that Murray McDonnell, assuming he was committing fraud, in fact had fraudulently obtained any money.
>
> "I don't find, certainly in the context of this case, that it was the duty of the stock exchange to screen the knowledge of the contributors to the capital of the company, given the circumstances we have before us on this trial; nor do I find that there is any duty as a matter of law, certainly in the context of this case, on

the stock exchange to inspect the signatures on the roll over of this debenture to see that Murray McDonnell did not commit the fraud that he is alleged to have committed.

"The proof as I remember it that went to the inspection of the trust instruments went to see whether the trust had the power to put the money into this kind of an instrument, not whether specific procedural steps had been in fact taken.

"As a result of this I don't see that the plaintiff could justify a 10(b) recovery against the exchange either with the exchange as a participant in this fraud in some way, or as an aider and abettor, or as a control person."

The trial court also dismissed plaintiffs' Section 6 claims against the Exchange to the extent that they sought to impose responsibility upon the Exchange for whatever fraud T. Murray McDonnell may have perpetrated upon the plaintiffs.[4] The court said (Vol. 7, Tr. 2360-2361):

"As far as the regulatory claim is concerned, I am withdrawing from the jury those aspects of it which impose a duty on the stock exchange to supervise the representations that McDonnell makes to anybody. I don't think Section 6 puts upon them a duty to supervise Murray McDonnell's statements to his sister.

"Mr. Beebe: Or to any outside—

"The Court: Or to any outside lender without being aware that there is some fraud involved.

[4] Plaintiffs in their brief on appeal (pp. 10, 18) complain that the charge on Section 6 failed to state that under certain circumstances a reasonable response must include disclosure by the Exchange to an investor in a member firm of the firm's condition. In so arguing, plaintiffs fail to recognize that the court dismissed that portion of their Section 6 claim prior to submitting the case to the jury and that therefore no such charge was proper.

"There is no history here that McDonnell & Company had ever failed to disclose information in the past, so the exchange was on notice that Murray would be running around the country committing frauds if he did. I don't see that you can infer this from the speed in which the money was gotten into the company, particularly where it's normal in this industry that speed is needed when there is a net capital violation.

"To contend to the contrary, as a matter of law, it seems to me the stock exchange would have to be present at family discussions and make sure that McDonnell said what the exchange felt it was obligated to say anyway under the securities law.

"I incorporated in there my thoughts earlier about putting the exchange in the position of being an insurer [which follow]."

* * *

"It seems to me that any other conclusion here would make the stock exchange an insurer because what you get into, as I see it, is if the exchange has a duty to supervise, let's say, what is told Mrs. Murphy, suppose they miss something and some very able lawyer like Walter Beebe is going to come in and say they didn't tell them item 6 and item 9, and alternatively if the stock exchange, bending over backwards to make sure they told them every item, tells them 25 items. The company is going to say 'We would have gotten this money and stayed alive if you had not told so many things' and the borrower says 'If the stock exchange took 25 minutes to tell me these things, I am not interested.'

"Also, a lender could claim that the stock exchange puts its primatur on the loan thus becoming involved. You would have an entirely different matter, in my judgment, if the exchange knew the money had been obtained by fraud. We don't have any such thing." (Vol. 7, Tr. 2359)

The court submitted to the jury all Rule 10b-5 claims against McDonnell and the Section 6 claims of all plaintiffs asserted against the Exchange for the alleged failure of the Exchange to enforce its rules in respect to McDonnell.

After deliberating during the afternoon of May 21, 1975 and most of the day of May 22, the jury returned a verdict in favor of the Exchange on all claims. The jury also found for McDonnell on the Rule 10b-5 claims of plaintiffs Anna McDonnell and James F. McDonnell, Jr., individually. However, the jury found for Mrs. Murphy on her Rule 10b-5 claim against McDonnell and for the trustees on their Rule 10b-5 claim against McDonnell for the exchange of the Debenture.

Plaintiffs' motions for judgment notwithstanding the verdict or for a new trial were denied.

Statement of the Facts

Plaintiffs' version of the facts (Br.[5] 11-16) ignores or distorts the evidence. There follows a full statement of the facts supported by the evidence.

In early 1969 McDonnell was one of the larger medium-sized member firms of the Exchange and the Amex, with approximately 26 branch offices throughout the United States and 50,000 customer accounts. (Vol. 6, Tr. 1912) McDonnell was the principal rights specialist on the Exchange. (Vol. 4, Tr. 1345-1347)

McDonnell was founded as a member firm of the Exchange in 1917 by James F. McDonnell, husband of plaintiff Anna McDonnell and father of plaintiffs James F. McDonnell, Jr. and Margaret Mary McDonnell Murphy, as well as of T. Murray McDonnell and Morgan McDonnell, the principals of McDonnell at all relevant times. Over the

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[5] "Br." refers to the designated pages of appellants' brief.

years, McDonnell prospered under the leadership of James F. McDonnell, as did the McDonnell family. At one time or another, each of the six McDonnell sons was associated with McDonnell. (Vol. 2, Tr. 326)

Upon the incorporation of McDonnell, the partnership interest of the then deceased James F. McDonnell was evidenced by a subordinated Series B Debenture of McDonnell in the principal amount of $318,622, maturing on December 31, 1968, and 797 shares of preferred stock of McDonnell. (Vol. 2, Tr. 423)

In 1962, T. Murray McDonnell on behalf of the firm had borrowed from his mother, Anna M. McDonnell, additional capital to help finance the expansion of McDonnell (Vol. 4, Tr. 1025) and to make good the defalcation of a major customer. (Vol. 2, Tr. 331) By agreement between McDonnell and Mrs. McDonnell dated June 29, 1962, Mrs. McDonnell subordinated securities having a market value of $1,823,858 to the claims of the creditors of McDonnell. (Ex.[6] JJ) In a subordinated investment, the investor retains all rights to dividends and distributions on the securities, as well as all other ownership rights such as voting the stock, and is paid interest on the market value of the securities. The firm can include subordinated assets in its net capital. Mrs. McDonnell's original subordination was renewed continually until the liquidation of McDonnell in 1970; throughout that time she was a substantial subordinated lender to McDonnell. (Vol. 4, Tr. 1032-1036)

Under the rules of the Exchange, McDonnell was required, before the Exchange would recognize Mrs. McDonnell's investment as good capital, to complete and submit to the Exchange an application for approval of her as a person of sufficiently good character to be an investor in an Exchange member firm. (Vol. 6, Tr. 1912-1913) Her character was found satisfactory and she was approved.

In 1965 or 1966, at the request of her brother Sean McDonnell, Mrs. Murphy loaned the securities in her ac-

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[6] "Ex." refers to the designated trial exhibit in the record.

count at McDonnell to Sean so that he in turn could loan the account to McDonnell for use in the business. (Vol. 1, Tr. 64, 126-128)

In the later years of the 1960's the volume of trading on both the stock exchanges and the over-the-counter market increased at a rate that was not anticipated. (Vol. 2, Tr. 610) As a result of so much unexpected business, many brokerage firms, as well as banks, had problems trying to keep up with the volume. The "paper crunch" led to many new and different problems for both the securities industry and the Exchange. One result of increased volume was increased errors in stock records. (Vol. 2, Tr. 611-612) Firms were also incurring great start-up expenses to replace manual or semi-automatic data keeping systems with highly automatic computer data keeping facilities capable of handling the heavy volume.

Exchange rules required that each year a member firm have a surprise audit of its books and records by an independent certified public accountant retained by the member firm for that purpose. (Vol. 6, Tr. 1889) The "big eight" accounting firm of Lybrand, Ross Bros. & Montgomery ("Lybrand") had been retained by McDonnell to perform these audits.

The Answers to Regular Financial Questionnaire for McDonnell as of October 22, 1967, the principal report certified by the auditors, was received by the Exchange in late February, 1968. It disclosed that recordkeeping problems existed at McDonnell on the audit date. (Vol. 6, Tr. 1916-1917) The problems revealed by the 1967 audit of McDonnell also were being encountered by other member firms at the time as a result of the paper crunch. Thus, in March the Exchange sent to all member firms a circular discussing procedures which could be utilized by the firms to alleviate recordkeeping problems. (Vol. 6, Tr. 1919-1920, Ex. 78)

As a result of the recordkeeping problems shown by the audit of McDonnell, the Exchange restricted McDonnell from opening new branch offices or entering into commitments to increase its business pending a series of discussions

at which McDonnell could explain to the Exchange what steps were being followed to improve its recordkeeping. (Vol. 6, Tr. 1918-1919, Ex. 79, E[7]-3) Additional restrictions were imposed prohibiting the transfer of registered representatives to McDonnell from other firms and withholding Exchange approval for new McDonnell trainees. (Ex. 80) The Exchange also required McDonnell to submit a plan to resolve non-current items, and required special operations questionnaires to be filed by the firm. On its own initiative, McDonnell reduced underwritings, advertising and firm trading. (Ex. KKK)

McDonnell showed steady improvement in its recordkeeping over the October 22, 1967 findings. Based upon the improvement and McDonnell's willingness to continue working to improve its recordkeeping system, the Exchange lifted the restrictions on April 19, 1968 with the admonition that the firm should be conservative in undertaking new business in light of its upcoming computer conversion and the recent heavy volume of trading in the securities market. (Vol. 6, Tr. 1922-1923, Ex. 81) During the summer McDonnell instituted restrictions to limit the number of small and difficult to execute transactions which generated excess paperwork. (Vol. 6, Tr. 1924-1925)

In the spring of 1968, McDonnell was required to submit to the Exchange special operations questionnaires on a monthly rather than quarterly basis and to report each month on the rate of recordkeeping correction. (Vol. 6, Tr. 1923-1924) The Exchange was satisfied that the firm was getting along reasonably, considering the general market conditions where very high unanticipated volume was putting a strain on the back offices of many member firms. (Vol. 6, Tr. 1924) Based upon data which the Exchange was receiving and reviewing from McDonnell in late 1968, the firm's operations had improved during the period from March 1968 to November 1968. (Vol. 6, Tr. 1960-1962) The

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[7] "E" refers to the Exhibit volume of the Joint Appendix where the designated exhibit may be found.

firm was reporting a net capital ratio of 1369 percent, slightly lower than the capital figure had been in March and April. (Vol. 6, Tr. 1963) At the time McDonnell did not appear to be in violation of any rules of the Exchange. (Vol. 3, Tr. 848)

As of October 31, 1968, Lybrand commenced the surprise audit of McDonnell for the calendar year 1968. Under the Exchange's 45-day rule for submission of the report of the auditors, Lybrand's report was due to be submitted to the Exchange on December 15, 1968. (Vol. 6, Tr. 1971) McDonnell requested of the Exchange two 15-day extensions, which were supported by a letter from Lybrand dated December 23, 1968, stating that the reasons for the delay were the untimely death of McDonnell's controller and a flu epidemic which had restricted personnel available to work on the audit. Lybrand's letter also gave the assurance that Lybrand had no reason to doubt that McDonnell met the Exchange's capital requirements as of the audit date (October 31, 1968) or currently (December 23, 1968). (Ex. DD)

On or about January 15, 1969, the Exchange and SEC received from Lybrand the Answers to the Regular Financial Questionnaire as of October 31, 1968. (Ex. Z) The Exchange's analysis of the data was completed on or about January 27, 1969. (Ex. AA) The analysis showed that as of October 31, 1968 McDonnell had been in violation of the net capital requirement of Exchange Rule 325, which prescribed 20 to 1 (usually expressed as 2,000 percent) as the maximum ratio for aggregate indebtedness to net capital. (Vol. 6, Tr. 1973) The SEC was advised of the capital rule violation. As a result of its analysis, the Exchange determined McDonnell to have a capital ratio of 2,717 per cent and to require a minimum of $500,000 in additional capital to bring itself into compliance. (Ex. 74)

While the Exchange analysis did show a net capital deficiency as of October 31, 1968, the Exchange also calculated McDonnell's net worth to be approximately $16 mil-

lion as of that date. (Ex. AA) Moreover, according to data available at the end of January, 1969, McDonnell had operated very profitably during the first eight months of 1968 and had shown profits for the years 1965 through 1967. (Vol. 6, Tr. 1911; Ex. 16, ex. C. thereto).

A meeting promptly was scheduled on January 29, 1969, between the Exchange and McDonnell. (Vol. 6, Tr. 1982-1983) Immediately prior to the meeting, the Exchange received a letter dated January 28, 1969 from McDonnell, detailing the actions taken by the firm to resolve its problems and explaining the reasons for the deterioration of operations. (Vol. 6, Tr. 1974, Ex. BB-1) McDonnell also advised that it had initiated additional restrictions including reducing firm trading positions and firm trading accounts, not recruiting additional trainees, not opening any new branch offices beyond one previously planned and approved, curtailing the advertising budget, and reducing small accounts and small commission tickets.

The January 28, 1969 letter also indicated that by that date McDonnell had increased its net capital by $845,000 since the audit date. (Vol. 6, Tr. 1976) McDonnell also reported that it had engaged McKinsey & Co., management consultants, to assist the firm in improving profitability and efficiency, instituted cyclical box counts, and hired six new officers experienced in corporate finance. (Ex. BB-1)

At the January 29 meeting, the Exchange instructed McDonnell that it would be required to bring its capital ratio within the required 2,000 percent by the end of that week (January 31) by a minimum improvement of $500,000, and that the firm would be required to further reduce its capital ratio to 1,500 percent within one month thereafter. (Ex. 74) At the meeting the spokesman for McDonnell said they would comply immediately. (Vol. 6, Tr. 1985) He did not say how. The Exchange did not tell McDonnell by what method it should improve its capital ratio. (Vol. 6, Tr. 1985-1986)

McDonnell complied with each of the conditions set by the Exchange, depositing by January 31 additional net

capital in the amount of $945,000. (Vol. 6, Tr. 1987, Ex. CC) On February 24, 1969, McDonnell assured the Exchange that by February 20 it had deposited an additional $2,440,000 of capital. (Ex. NNN) In addition, the Exchange received further assurances from McDonnell that it would cut back its business and undertake certain steps to resolve its recordkeeping problems, which in great part had accounted for its violation of the capital rule. (Ex. NNN)

The addition to capital of January 30, 1969 consisted of a deposit to the already existing subordinated account of Anna McDonnell of securities with a market value of approximately $1,136,425 and a deposit to the already existing subordinated account of Marjorie F. McDonnell (wife of Murray McDonnell) of securities having a market value of approximately $222,852. (Ex. CC) The Exchange learned of these additional contributions only after they had been effected between McDonnell and the capital contributors. (Vol. 6, Tr. 1987) Upon application of the 30% "haircut" to the market value of the newly deposited securities,[8] McDonnell had increased its net capital under Exchange Rule 325 by approximately $945,000. (Vol. 6, Tr. 1987)

The increase in the capital of McDonnell of $2,440,000 which the Exchange had been assured had occurred by February 20, 1969 in part reflected the subordinated investment of Mrs. Murphy of securities having a total market value of approximately $288,433. (Ex. 3)

The additional deposit to the account of Anna McDonnell was requested by Murray McDonnell. (Vol. 1, Tr. 218) At the time of the request, Mrs. McDonnell, as a result of frequent communications with Murray, was informed of the problems the firm was encountering. Mrs. McDonnell admitted that she could not deny that Murray had advised her of the profitability, capital, and

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[8] The Exchange's Rule 325 required a subtraction ("haircut") of 30% from the market value of all freely marketable securities to insure that no more than their liquidation value would be included in a firm's net capital.

back office condition of McDonnell at the time she made the deposit in late January, 1969. (Vol. 4, Tr. 1042-1043) Mrs. McDonnell also admitted that she knew that the condition of the firm was worse in January, 1969, than it had been in June, 1962, when she made her initial subordinated investment in McDonnell. (Vol. 4, Tr. 1042) Again, as in 1962, James McDonnell, Jr. counselled his mother against investing in McDonnell in a telephone conversation on January 29 which was followed up by a letter the next day. (Vol. 2, Tr. 234, 346-347) He wrote that "six years is more than sufficient time for McDonnell & Co. to solve their long-term capital requirement problem" and that subordinating new securities exposed Mrs. McDonnell to unnecessary risks and "raises potential future family problems too unpleasant to contemplate." (Vol. 2, Tr. 346-347)

However, Mrs. McDonnell testified that she had no hesitancy in responding affirmatively to Murray's request for help for the family firm because, as she said, "Any child had what they wanted if I could give it to them, help them out." (Vol. 4, Tr. 1041) She answered an interrogatory in a similar vein: "As T. Murray McDonnell is my son I agreed to subordinate my account at McDonnell in 1962 and 1965 and, as was the case in 1969, to contribute to my already subordinated account." (Vol. 4, Tr. 1053)

Mrs. McDonnell was certain that she had no communication with the Exchange in respect to her investment in McDonnell. (Vol. 1, Tr. 230-231)

The subordinated investment of Mrs. Murphy was requested by Murray McDonnell in a telephone conversation on or about February 3, 1969. (Vol. 1, Tr. 139) At this time Margaret, Murray's sister and godchild, had a cash and margin account at McDonnell. (Vol. 5, Tr. 1745) Margaret agreed to make a subordinated investment of securities as a favor to her brother, just as she previously had agreed to loan her account to Sean for use by McDonnell. (Vol. 1, Tr. 64, 147) Although Robert Murphy,

Margaret's husband, suggested that the Murphys look into the proposed subordination, Mrs. Murphy declined, replying "Don't you trust my family." (Vol. 1, Tr. 79-80)

The next morning Murray McDonnell sent his chauffeur to the Murphy home at 6:00 A.M. with a subordination agreement and related documents. Mrs. Murphy testified that she signed the documents that the chauffeur presented and that he left in three or four minutes with the signed documents. She denied having read any of the documents. (Vol. 1, Tr. 165)

The documents signed by Mrs. Murphy were a subordination agreement, two letters addressed to McDonnell certifying that she was competent to contract and that her securities were not restricted as to sale, and an application to the Exchange for approval of herself as a person of sufficiently good character to be an investor in an Exchange member firm. Mrs. Murphy's application to the Exchange was signed and submitted by her brother Morgan McDonnell, a member of the Exchange and a vice president of McDonnell. (Ex. A) Mrs. Murphy's character was found satisfactory and she was approved by the Exchange. Mrs. Murphy had no communication with the Exchange. (Vol. 1, Tr. 40)

A detailed capital computation prepared as of January 30, 1969 by McDonnell and submitted to the Exchange showed a ratio of 1886 percent. (Ex. 28) The special financial questionnaire as of January 30, 1969 (Ex. 43a), which plaintiffs contend (Br. 15) showed McDonnell to have a capital ratio of 3825 percent, was not received by the Exchange until February 28, 1969. (Ex. 43a) Not until April 24, 1969, as a result of a visit to McDonnell by Exchange examiners from February through April, could the Exchange determine that adjustments in McDonnell's computations were appropriate. (Exs. 25, 28) T. Murray McDonnell personally borrowed $1,650,000 from First National City Bank and invested the proceeds as capital in

McDonnell, thus correcting the deficiency created by the Exchange's adjustments. (Vol. 6, Tr. 2018-2019)

The Exchange also requested that McDonnell produce a work plan to resolve the operations problems. (Vol. 6, Tr. 2008-2012; Ex., GG, E-65) McDonnell submitted a comprehensive work plan. (Ex. TT, E-71)

In the early spring the SEC also began its own close surveillance of the situation at McDonnell. The SEC had received a copy of the firm's Answers to Regular Financial Questionnaire. Consequently, the SEC sent its examiners to McDonnell and had been in contact with the Exchange to coordinate regulatory programs in respect to McDonnell. (Vol. 4, Tr. 1154-1155) McDonnell agreed to furnish the SEC with copies of McDonnell's weekly statements of the firm's estimated capital position. (Vol. 4, Tr. 1157-1158) The first such report which was sent to the SEC was McDonnell's statement of its capital position as of April 21, 1969. The SEC was also fully informed of the voluntary restrictions under which McDonnell was operating. (Ex. OOO, E-99)

The SEC continued to receive essentially the same information in respect of McDonnell which the Exchange received, and kept close track of the situation. McDonnell forwarded to the SEC copies of its monthly special operations questionnaires, and semi-monthly progress reports under the workplan. (Vol. 4, Tr. 1168-1170; Ex. VV, E-105; Ex. WW, E-116; Ex. YY, E-125; Ex. ZZ, E-135; Ex. AAA, E-142; Ex. BBB, E-149; Ex. CCC, E-161) During the summer of 1969, the SEC performed an oversight inspection of the Exchange's activities with regard to McDonnell. Documents from the Exchange's files relating to McDonnell were examined and copied by the SEC. (Vol. 6, Tr. 2041-2043; Ex. SSS, E-159; Ex. TTT, E-160)

Subsequently, the Exchange added to the self-imposed restrictions under which McDonnell had been operating by further restricting the business of the firm. (Vol. 6, Tr. 2024-2025) The Exchange prohibited the registration of any new

registered representatives or producing allied members; required the number of trades handled be limited to 12,000 per week, including underwritings; and prohibited all advertising and sales promotion, except that incidental to underwritings. (Vol. 6, Tr. 2025-2066, Ex. 56a, E-119) Throughout the spring, the firm's capital position continued to hover around the 2,000 percent ratio.

In June, 1969, Tom McKay, the head of McDonnell's back office, died, leaving a severe gap in management. For the first time, Murray McDonnell and other members of the McDonnell operation, including James F. McDonnell, Jr., who actively solicited additional capital, were unable to attract new capital. (Vol. 5, Tr. 1815, Vol. 6, Tr. 2057-2058) Merger discussions with other member firms proved unfruitful. (Vol. 5, Tr. 1799) McDonnell sold a number of its seats on the Exchange and the Amex and obtained full capital credit for the cash. (Vol. 2, Tr. 396-398) Paul McDonald was engaged to direct the firm's retrenchment efforts. He was a long-time friend of the McDonnell family, a lawyer and a highly successful businessman, with a reputation as a troubleshooter who had the ability to turn around difficult situations.

In late August or early September, to bolster McDonnell's capital condition, Paul McDonald and Tom Ford, Esq., of Shearman & Sterling, counsel to McDonnell, worked out a capital reorganization of the firm. (Vol. 6, Tr. 1815-1816)

On or after September 12, 1969, Anna M. McDonnell and James F. McDonnell, Jr., as trustees under the Will of James F. McDonnell, sent a letter to McDonnell, attention T. Murray McDonnell, with copies to all board members, Tom Ford, Lybrand, and Paul McDonald. (Vol. 2, Tr. 428-431) In substance, the letter contended that the Debenture had been exchanged without authorization of the trustees. The letter demanded return of the original certificate but did not demand payment of the Debenture. The trustees

never notified the Exchange about the allegedly improper rollover. (Vol. 2, Tr. 431)

The statement of financial condition of McDonnell as of October 31, 1968, with the certified report of Lybrand dated January 12, 1969, contained the following footnote:

> "On December 31, 1968, the Series A and Series B Registered Subordinated Debentures were exchanged (except for an amount of $80,000 redeemed for cash) for a new issue of debentures, Series E, maturing December 31, 1978, with interest at a per annum rate of 2 per cent in excess of the prime rate." (Vol. 2, Tr. 495; Ex. J)

Lybrand's audit report recognized that Murray McDonnell had apparent authority as trustee to exchange the Debenture. The Exchange, never hearing to the contrary from any trustee, throughout 1969 and early 1970 relied upon Lybrand's audit report to accord capital credit to the Series E Debenture registered in the name of the trustees. (Vol. 3, Tr. 723-724)

The capital reorganization of McDonnell proved only a stopgap measure. During the fall of 1969, the firm continued to cut expenses and its need for capital by selling and closing branch offices. The objective of the firm became reduction in size to a New York operation with a headquarters office and one or two branch offices, retaining its historic rights business, which had always been profitable, Murray McDonnell's institutional sales, and its underwriting operation. Expenses continued to run higher than income and erode capital because the firm still had to employ a large back office staff to clear up past recordkeeping errors in order to deliver out customer accounts. During the fall of 1969, according to the weekly reports filed by the firm, McDonnell's capital ratio hovered below 2000 percent. (Exs. GGG, HHH)

Lybrand commenced its 1969 surprise audit of McDonnell on December 19, 1969. The audit report was due on

February 2. McDonnell requested an extension (Vol. 6, Tr. 2049), which was supported by a letter dated February 2 from Lybrand in which Lybrand stated that it had been unable to compute the firm's net capital and that it doubted that the firm had been meeting the capital requirements as of December 19, 1969, or currently. (Ex. UUU) The poor state of McDonnell's records was the principal reason given by Lybrand for the need for an extension. The Exchange did not grant the extension. (Vol. 6, Tr. 2051)

The Exchange and McDonnell realized that the firm would have to cease doing business. However, the Exchange permitted the firm to continue for several weeks after February 2, 1970, despite the probability that McDonnell was operating in violation of the Exchange's net capital rule, so that McDonnell could deliver out the remaining customer accounts and scale down the firm to a manageable liquidation situation. (Vol. 6, Tr. 2051-2055)

The SEC acted in a parallel manner. Paul McDonald testified about his meeting with Chairman Budge of the SEC as follows:

> "So I explained to him what the situation was, what we had done, what the progress had been, and I had clearly identified in my own mind the night before that if we had about six weeks more we could probably get done about all that could be done. I didn't ask for six weeks. I was simply informing him of the risk that might be avoided with six weeks more of effort." (Vol. 5, Tr. 1820-1822)

Approximately six weeks later, on March 13, 1970, McDonnell announced to the public its plan for orderly termination of business.

ARGUMENT

I

The Trial Court's Charge Properly Described the Exchange's Capital Rule

The court charged on the capital rule that:

> "Rule 325 establishes net capital requirements for exchange members which at all material times in this action required that, 'No member'—of the exchange—'shall permit in the ordinary course of business as a broker its aggregate indebtedness to exceed 2,000 percentum of its net capital,' as that latter term is defined and computed under Rule 325.
>
> "The quote goes on, 'unless specific temporary exception is made by the exchange in case of a particular member or member organization due to unusual circumstances.'
>
> "Then, or alternatively under Rule 325, the exchange is permitted in the case of a particular member or member organization to prescribe stricter net capital requirements. Thus, I want it to be clear that they could make the tough [*sic:* it tougher] or easier under the rules as they existed." (Vol. 8, Tr. 2659)

Plaintiffs argue that the charge constitutes error because: (A) the text of the rule does not authorize "a specific temporary exception" to the required ratio; (B) the charge does not take into account the requirement of Section 8(b) of the Exchange Act, 15 U.S.C. § 78(h)(b), that a member of a national securities exchange could not "in the ordinary course of business as a broker" permit his aggregate indebtedness to exceed 2000 percent of his "net capital employed in the business"; (C) there was no evidence in the record to suggest that an exception to Rule 325 had been made in the case of the Exchange's regulation of McDonnell; and (D) the Exchange's counsel had stated that the

Exchange was not contending an exception had been made. Plaintiffs' arguments cannot withstand analysis.

A. Rule 325 provides that the Exchange can make an exception to the capital ratio requirement.

Rule 325[9] (Exs. 34, 35) is many pages long. Subsection (a) of the rule specifies the 2000 percent ratio and authorizes both a temporary exception and a stricter requirement:

> "Rule 325. (a) No member or member organization doing any business with others than members or member organizations or doing a general business with the public, except a member or member organization subject to supervision by State or Federal banking authorities, shall permit, in the ordinary course of business as a broker, his or its Aggregate Indebtedness to exceed 2000 per centum of his or its Net Capital, which Net Capital shall be not less than $50,000 in the case of a member organization carrying any accounts for customers and shall be not less than $25,000 in the case of any other member or member organization subject to this rule, unless a specific temporary exception is made by the Exchange in the case of a particular member or member organization due to unusual circumstances.
>
> "The initial Net Capital of a member corporation shall be at least 120% of the Net Capital required to be maintained by this rule.
>
> "The Exchange may at any time or from time to time in the case of a particular member or member organization prescribe greater requirements than those prescribed herein.
>
> "Each member or member organization shall promptly notify the Exchange if his or its Net Capital

[9] The entire text of Rule 325 is printed in the Addendum to this brief at pages A-1 et seq.

does not equal or exceed the minimum required by this rule."

There can be no doubt that the last clause of the first paragraph of Rule 325(a) provides that the Exchange may except a member organization from the 2000 percent requirement. The positioning of commas in that paragraph precludes plaintiffs' interpretation (Br. 22, n) that the exception clause relates to the minimum dollar amounts of capital of $50,000 and $25,000.

If the text of the rule left any doubt, the record makes clear that the exception applied to the requirement of the 2000 percent ratio. Robert M. Bishop, who in 1968 through 1970 was the Exchange's vice president in charge of its Department of Member Firms, testified:

"Q. During this period would you be in agreement with the statement that the rule provided a maximum capital ratio of 2000 percent from member firms?

"A. Yes.

"Q. Did the department of member firms or other responsible officers of the exchange have the authority to grant an exception to that rule?

"A. Yes.

"Q. Did the same officers have authority to make a more stringent requirement on a particular member firm?

"A. Yes." (Vol. 6, Tr. 1900)

If there is any ambiguity in Rule 325, the Exchange is the proper party to interpret its own rule. *Intercontinental Industries, Inc.* v. *American Stock Exchange*, 452 F.2d 935, 940 (5th Cir. 1971), *cert. denied,* 409 U.S. 842 (1972); *Aronson* v. *McCormick,* 13 Misc.2d 1077, 178 N.Y.S.2d 957, 959, (Sup. Ct.), *aff'd,* 6 A.D. 2d 999, 177 N.Y.S.2d 1004 (1st Dept. 1958).

Furthermore, plaintiffs are barred from arguing that the charge did not conform to the text of Rule 325. Plaintiffs did not object to the charge on the ground that it did not conform to the text of the rule. (Vol. 8, Tr. 2647-2650) Rule 51, Federal Rules of Civil Procedure, provides that an objection and its grounds must be stated before the jury retires so that the trial court may correct its instruction if the objection is well taken. *Palmer* v. *Hoffman*, 318 U.S. 109, 119 (1943); 9 Wright & Miller, *Federal Practice and Procedure* § 2554 (1971). For this reason, a charge cannot be challenged on one ground in the trial court and on a different ground on appeal. *Bailey* v. *Baltimore and Ohio R.R.*, 227 F.2d 344, 347 (2d Cir. 1955); *O'Connell* v. *Naess*, 176 F.2d 138, 140 (2d Cir. 1949); *Nanda* v. *Ford Motor Company*, 509 F.2d 213, 224 (7th Cir. 1974); *Gillentine* v. *McKeand*, 426 F.2d 717, 723 (1st Cir. 1970); *Siegfried* v. *Kansas City Star Co.*, 298 F.2d 1 (8th Cir.), *cert. denied*, 369 U.S. 819 (1962); *Stilwell* v. *Hertz Drivurself Stations, Inc.*, 174 F.2d 714 (3d Cir. 1949).

B. Section 8(b) of the Exchange Act is not applicable.

Plaintiffs contend (Br. 16-25) that Section 8(b) of the Exchange Act prohibited the Exchange from permitting any member firm to exceed the 2,000 percent ratio prescribed in the Exchange's Rule 325, irrespective of the language of Rule 325. At no time before this appeal have plaintiffs raised the applicability of Section 8(b). Plaintiffs therefore are barred on this appeal from challenging the trial court's charge on the basis of Section 8(b). *Bailey* v. *Baltimore and Ohio R.R.; O'Connell* v. *Naess; Nanda* v. *Ford Motor Company; Gillentine* v. *McKeand; Siegfried* v. *Kansas City Star Co.; Stilwell* v. *Hertz Drivurself Stations, Inc.*, all *supra.*

Had plaintiffs raised the issue of Section 8(b) before, it quickly would have become apparent that Section 8(b) does not apply. Section 8(b), which was repealed by

Section 5(2) of the Securities Acts Amendments of 1975, Pub.L.No. 94-29, 89 Stat. 97 (June 4, 1975), provided:

> "Restrictions on Borrowing by Members, Brokers, and Dealers
>
> "*Section 8.* It shall be unlawful for any member of a national securities exchange, or any broker or dealer who transacts a business in securities through the medium of any such member, directly or indidirectly—
>
> * * * * *
>
> "(b) To permit in the ordinary course of business as a broker his aggregate indebtedness to all other persons, including customer's credit balances (but excluding indebtedness secured by exempted securities), to exceed such percentage of the net capital (exclusive of fixed assets and value of exchange membership) employed in the business, but not exceeding in any case 2,000 per centum, as the Commission may by rules and regulations prescribe as necessary or appropriate in the public interest or for the protection of investors."

As its title shows, Section 8(b) was a restriction on borrowing, not a measure of the financial responsibility of a broker-dealer. Compare Section 15(c)(3), 15 U.S.C. § 78o(c)(3), discussed *infra*. Section 8(b) restricted only the borrowings incurred in a member's business "as a broker" to an amount that did not exceed 2,000 percent of his net capital "employed in the business". Compare Section 8(a), which restricted borrowings in the ordinary course of business "as a broker or dealer". Shortly after enactment, it became clear that it was extremely difficult to sort out a firm's brokerage business from its business as a dealer or underwriter or investment advisor so as to meet the strictures of Section 8(b). The SEC, in fact, never prescribed any rules or regulations under Section 8(b). The SEC, rather, sought amendment of Section 15(c)(3).

Loss has described the early demise of Section 8(b) as follows:

> "And even as to those broker-dealers who are covered, the section applies only to indebtedness incurred in the normal course of their brokerage business; apart from the diffculty of segregating a broker-dealer's indebtedness incurred in the course of his brokerage business from that incurred in his business as a dealer, the section is inadequate in failing to recognize that the obligations of a broker outside of his business frequently subject customers to the same types of risks as obligations incurred in his securities business, whether as a broker or as a dealer. Although the twenty-to-one ratio of § 8(b) was early applied [pre-1943] in a few clear cases of insolvency on the theory that the section is self-executing, these difficulties have discouraged the Commission from implementing the Section by rule.
>
> Instead the Commission has acted under § 15(c)(3), a more general provision added in 1938 to prohibit *any* broker or dealer from using the mails or interstate facilities to effect any transaction in, or to induce the purchase or sale of, any security (other than an exempted security or commercial paper, bankers' acceptances or commercial bills) otherwise than on a national securities exchange 'in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors to provide safeguards with respect to the financial responsibility of brokers and dealers.' " II Loss, *Securities Regulation,* pp. 1350-1351 (1961)

Under its rule 15(c)(3), 17 C.F.R. 240.15c3 (1969), the SEC prescribed a net capital rule prohibiting aggregate indebtedness from exceeding 2,000 percent of a broker-dealer's net capital, but exempted from the operation of its rule members of those national securities exchanges

which, in the SEC's judgment, had more comprehensive capital rules. The Exchange was specifically named as such an exchange. See SEC Rule 15c 3-1(b)(2), 17 C.F.R. § 240.15c 3-1(b)(2)(1969). Unlike Section 8(b), the SEC's rule applied to the aggregate indebtedness and net capital of a broker-dealer arising from all aspects of its business. II Loss, *Securities Regulation*, pp. 1353-1355 (1961). The Exchange's net capital rule similarly applies to the entire aggregate indebtedness and net capital of a member firm such as McDonnell. "Aggregate indebtedness" is defined to mean "total money liabilities". Rule 325(b)(2), *infra*, at A-2. "Net capital" is defined to mean "Net Worth" with certain adjustments to reflect liquidity. Rule 325(b)(4), *infra*, at A-3.

All evidence of McDonnell's net capital ratio are computations made under Rule 325. The Rule 325 computations are entirely different than a computation that would be made under Section 8(b).[10] If plaintiffs now seek to contend that the Exchange failed to enforce Section 8(b) of the Exchange Act, they have put in no evidence to show what McDonnell's computation would be under Section 8(b).

Furthermore, the regulatory scheme of the Exchange Act precludes any conflict between Section 8(b) and Rule 325. Under Section 6(a) of the Act, 15 U.S.C. § 78f(a), upon its registration as a national securities exchange, the Exchange was required to submit its constitution and rules

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[10] One simple illustration of a difference is that Section 8(b) talks of "net capital (exclusive of fixed assets and value of Exchange membership) employed in the business [as a broker]". McDonnell enjoyed a broad spectrum of business: retail broker, rights dealer, underwriter, and investment advisor. Therefore, the Exchange's computation under Rule 325 would look to the aggregate indebtedness and net capital of McDonnell for all its sources of business. Section 8(b) would look only to McDonnell's business as a broker. Another difference would be that net capital under Section 8(b) would include securities owned by McDonnell, either at market value or at cost, assuming that the section leaves to ordinary accounting principles the valuation of securities. The Exchange's Rule 325 "haircutted" by 30 percent the market value of securities. See Rule 325(b)(4)(B), *infra* at A-4.

to the SEC and the SEC was required to find that the rules were "just and adequate to insure fair dealing and to protect investors." Thereafter, the Exchange was required to furnish to the SEC copies of any amendments to its rules upon their adoption. Section 6(a) (4). Under Section 19(b) of the Act, 15 U.S.C. § 78s(b), the SEC was authorized to order any changes in the Exchange's rules that it determined "necessary or appropriate for the protection of investors" in respect of thirteen specific matters, the first of which was "safeguards in respect of the financial responsibility of members." The SEC exempted members of the Exchange from the application of the SEC's capital rule on the ground that the Exchange's rule was more comprehensive.

The SEC's approval of the Exchange's capital rule comes close to precluding review of the issue of whether Rule 325 squares with Section 6(b). As the Court of Appeals for the Ninth Circuit said in *Hughes* v. *Dempsey-Tegeler & Co., Inc.*, 534 F.2d 156 (9th Cir. 1976), *cert. denied*, ---- *U.S.* ---- (Oct. 18, 1976):

> "The involvement of the Commission in a case is significant because it is the governmental authority charged with the enforcement of the provisions of the Securities Exchange Act . . . If the Commission expressly endorses a particular regulatory action taken by an exchange, that endorsement should properly be given considerable weight by a court hearing a claim that the same action constitutes a violation of the exchange's Section 6 duty." (534 F.2d at 170)

See *Gordon* v. *New York Stock Exchange, Inc.*, 422 U.S. 659 (1975).

Congress did not intend that the judiciary should, without great hesitancy, determine the facts or substitute its judgment for that of the SEC, which has "intimate familiarity with the characteristic features of the [securities]

industry. . . ." *United States* v. *Morgan,* 118 F.Supp. 621, 699 (S.D.N.Y. 1953); *Stark* v. *New York Stock Exchange, Inc.,* 346 F.Supp. 217 (S.D.N.Y.), *aff'd,* 466 F.2d 743 (2d Cir. 1972).

C. There was substantial evidence to justify charging the exception language of Rule 325.

Bishop testified that from the time the Exchange received a letter from Lybrand dated February 2, 1970 (Ex. UUU), in which Lybrand expressed doubt that McDonnell was in capital compliance, up until March 13, 1970, the date McDonnell entered liquidation, the Exchange accepted the fact that McDonnell probably was not in capital compliance. The Exchange permitted McDonnell to remain in business solely because McDonnell needed approximately six weeks to deliver out customer accounts. (Vol. 6, Tr. 2050-2055) Normally a firm in violation of the capital rule with no prospect for immediate correction of the violation would have been suspended. Paul McDonald, who was then running McDonnell, testified that he had obtained for McDonnell a similar exception from suspension by the SEC. (Vol. 5, Tr. 1819-1821)

This evidence, from which a jury could infer that an exception to the required ratio of 2000 percent had been made, is not contradicted by the testimony cited by plaintiffs (Br. 24) to the effect that the Exchange had not suspended or departed from its rules, or the fact that the Exchange's charge memorandum (Ex. 83, E-211-212) did not allege that McDonnell had violated the Exchange's capital rule from February 2 to March 13, 1970. Since Rule 325 provided for an exception, it would not have been necessary to suspend the rules for McDonnell or to depart from the rules or to charge McDonnell with a capital violation for the February to March 1970 period if an exception had been made. Such an event would have been the working of the rule as drafted.

D. The exception provision was never withdrawn from the case.

Counsel for the Exchange never withdrew the exception issue. The statement to which plaintiffs continually refer is from counsel's argument in support of the Exchange's motion for a directed verdict (see Vol. 5, Tr. 1443) at the close of plaintiffs' case but before defendants' evidence had been received. Counsel said:

> "The capital rule doesn't authorize shutting a firm down because there is a violation of the capital rule. In fact, the capital rule says that the exchange can make an exception to the rule.
>
> "I don't contend that was made here, but I think it shows that this is not a go or no-go situation. The exchange article 14 of the constitution provides that there can be disciplinary proceedings brought to determine whether there has been a violation, and if so, what." (Vol. 5, Tr. 1488)

Until the Bishop testimony was received, there was no evidence to support a contention that an exception had been made. The contrary was true at the close of all the evidence. On summation, counsel for the Exchange summarized the evidence on the February 2 to March 13 period. (Vol. 7, Tr. 2470-2471) The charge was justified by the evidence.

E. A re-reading of the corrected charge was required.

When the trial court in its charge initially described Rule 325, it said:

> "Rule 325 establishes net capital requirements for the exchange members which at all material times in this act required that 'No member'—this is of the exchange—'No member shall permit in the ordinary course of business as a broker its aggregate indebtedness to exceed 2000 percentum of its net capital,' as that latter term is defined and computed under Rule 325; and then it goes on to, 'Unless a specific temporary exception is made by the exchange in the case of a

particular member or member organization due to unusual circumstances.'

"Thus, under Rule 325 the exchange is permitted in the case of a particular member organization to prescribe stricter net capital requirements." (Vol. 8, Tr. 2630-2631)

After the charge had been read, Exchange counsel pointed out the incongruity in the charge. (Vol. 8, Tr. 2648-2649) The court then supplemented its initial charge by restating the ratio requirement of Rule 325 and saying:

"The quote goes on, 'unless specific temporary exception is made by the exchange in case of a particular member or member organization due to unusual circumstances.'

"Then, or alternatively under Rule 325, the exchange is permitted in the case of a particular member or member organization to prescribe stricter net capital requirements. Thus, I want it to be clear that they could make the tough [*sic:* it tougher] or easier under the rules as they existed." (Vol. 8, Tr. 2659)

The Court's re-reading of its charge was required because its initial reading contained an incongruity: it did not follow from the fact that an exception was authorized that "[t]hus" the Exchange could require "stricter net capital requirements." Plaintiffs' objection (Br. 23-25) to the court's restating its charge is ill-founded.

II

The Trial Court Properly Dismissed Plaintiffs' Disclosure Claims Against the Exchange

The trial court's oral decision dismissing plaintiffs' disclosure claims against the Exchange is set forth *supra* at pp. 4-6. The decision was correct because ". . . reasonable men

could not reach differing conclusions on the issue. . . ." *Radiation Dynamics, Inc.* v. *Goldmuntz,* 464 F.2d 876, 885 (2d Cir. 1972); *Fleming* v. *McEnany,* 491 F.2d 1353, 1357 (2d Cir. 1974).

Plaintiffs nevertheless contend (Br. 25-29) that the Exchange had a duty of disclosure. They argue disclosure only on behalf of Mrs. McDonnell and Mrs. Murphy. (Br. 29) However, Mrs. McDonnell's claim is barred. Her disclosure claim against McDonnell was submitted to the jury. It returned a verdict in favor of the firm. Thus, it is the law of this case that McDonnell made no misrepresentations or omissions to Mrs. McDonnell. There was nothing further to be disclosed by the Exchange, even if it had a duty to make disclosure to Mrs. McDonnell. Nor can it be said that the Exchange breached a duty under Section 6 in respect of McDonnell's disclosure to Mrs. McDonnell, because the jury decided that the firm did what was required.[11]

A. Plaintiffs Had No Claim Under Rule 10b-5

As a non-participant in the purchase and sale transactions, the Exchange had no duty to disclose information about McDonnell to plaintiffs. Accordingly, the Exchange cannot be held liable under Rule 10b-5. *Hochfelder* v. *Midwest Stock Exchange,* 350 F.Supp. 1122 (N.D.Ill. 1972), *aff'd,* 503 F.2d 364 (7th Cir.), *cert. denied,* 419 U.S. 875 (1974); *Wessel* v. *Buhler,* 437 F.2d 279 (9th Cir. 1971); *Beebe* v. *McDonnell & Co., Inc.,* 70 Civ. 1010 (N.D.Ill. 1972) (findings of fact and conclusions printed *infra* at A-40 *et seq.*).

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[11] While plaintiffs nominally appeal from the jury's decision in favor of McDonnell on Mrs. McDonnell's claim (Br. 2), they raise no issue applicable to that decision, with the exception of plaintiffs' issue No. 6 (Br. 4), challenging the trial court's admission of evidence as to the plaintiffs' family relationships and connections. As shown *infra,* no error can be attached to the admission of such evidence, let alone a denial of substantial justice.

In *Wessel,* the court said:

> "We find nothing in Rule 10b-5 that purports to impose liability on anyone whose conduct consists solely of inaction. On the contrary, the only subsection that has any reference to an omission, as distinguished from affirmative action, is subsection (2) providing that it is unlawful 'to omit to state a material fact necessary in order to make the statements made . . . not misleading,' i.e., an omission occurring as part of an affirmative statement. (*See* Brennan v. Midwestern United Life Insurance Company (7th Cir. 1969) 417 F.2d 147, 154-155). We perceive no reason, consonant with the congressional purpose in enacting the Securities and Exchange Act of 1934, thus to expand Rule 10b-5 liability. (*Cf* SEC v. Texas Gulf Sulphur Co., supra, 401 F.2d at 866-868 (J. Friendly, concurring specially)) On the contrary, the exposure of independent accountants and others to such vistas of liability, limited only by the ingenuity of investors and their counsel, would lead to serious mischief." (437 F.2d at 283)

In *Beebe* v. *McDonnell & Co., Inc.*, the court concluded:

> "3. The New York Stock Exchange is a person who was not a party to the purchase and sale transaction by which plaintiff Terrill acquired his stock [in McDonnell]. Furthermore, the Exchange's conduct consisted solely of inaction. It therefore can have no liability to plaintiff under Rule 10b-5." (A-42, *infra*)

This principle has been confirmed by the *en banc* decision of this Court in *Lanza* v. *Drexel & Co.*, 479 F.2d 1277 (2d Cir. 1973). The Court in *Lanza* cited *Wessel* v. *Buhler, supra,* (479 F.2d at 1300) and then concluded:

> "We recognize that *participation* by a director in the dissemination of false information reasonably calculated to influence the investing public may subject such a director to liability under the Rule. But it is

quite a different matter to hold a director liable in damages for failing to insure that all material, adverse information is conveyed to prospective purchasers of the company's stock absent substantial participation in the concealment or knowledge of it. Absent knowledge or substantial participation we have refused to impose such affirmative duties of disclosure upon Rule 10b-5 defendants." (479 F.2d at 1302)

If a director has no duty "to insure that all material, adverse information is conveyed" by those who are privy to the transactions, clearly the Exchange, a party even more remote from plaintiffs' transactions, can have no such duty. The Exchange cannot be held to presume fraud by its members when they deal with capital contributors, much less fraud by one member of a family upon another. McDonnell was a respected member firm which dealt with disclosure issues constantly in the course of its underwriting and investment advisory business. Obviously, the Exchange had no duty to monitor every discussion concerning capital contributions to McDonnell or to know the content of every statement made by McDonnell to plaintiffs. Indeed, such a proposition would be absurd! Yet, that is what plaintiffs' disclosure claims against the Exchange come down to.

The Exchange did not learn of the investments of Mrs. Murphy or Mrs. McDonnell until after they had been effected. (Vol. 6, Tr. 1987) The role of the Exchange in respect to Mrs. Murphy's investment was limited to approval of an application (Ex. A), signed and submitted by her brother, Morgan McDonnell, a member of the Exchange, for approval of Mrs. Murphy as of sufficiently good character to be an investor in an Exchange member firm. Mrs. McDonnell's investment required no approval because she simply increased her deposit in an already existing subordinated account, which had been open since 1962, and for which no approval was necessary in 1969.

In *Weinberger v. New York Stock Exchange*, 403 F.Supp. 1020 (S.D.N.Y. 1975), plaintiff claimed that approval by the

Exchange of his limited partnership application made the Exchange a "participant" and created a duty on behalf of the Exchange to disclose any material adverse information which it knew about the firm. The court concluded otherwise:

> "[T]he rendering of approval of plaintiff's admission as a limited partner in Haupt created no duty of disclosure on behalf of Exchange which could give rise to a direct violation of section 10(b) and Rule 10b-5. *See Lanza* v. *Drexel & Co.,* 479 F.2d 1277 (2d Cir. 1973); *Wessel* v. *Buhler,* 437 F.2d 279 (9th Cir. 1971); *Fischer* v. *Kletz,* 266 F.Supp. 180 (S.D.N.Y. 1967)." (403 F.Supp. at 1026)

There is, furthermore, no evidence to show that the Exchange acted with the "guilty knowledge" or "scienter" required by *Ernst & Ernst v. Hochfelder,* 425 U.S. 185 (1976), *Cohen* v. *Franchard,* 478 F.2d 115, 123 (2d Cir.), *cert. denied,* 414 U.S. 857 (1973), and *Lanza* v. *Drexel & Co., supra.* Nor did plaintiffs exercise the due care required by such cases as *City National Bank of Fort Smith, Ark* v. *Vanderboom,* 422 F. 2d 221 (8th Cir.), *cert. denied,* 399 U.S. 905 (1970) and *Rochez Bros., Inc.* v. *Rhoades,* 491 F. 2d 402, 409 (3d Cir. 1974), *cert. denied,* ___ U.S. ___ (1976).

Plaintiffs appear to base their Rule 10b-5 argument (Br. 27) on cases in which there was active solicitation by the defendant. (Br. 26-27) In *Fischer* v. *New York Stock Exchange,* 408 F.Supp. 745 (S.D.N.Y. 1976), the district court denied the Exchange's motion, made before answering, to dismiss or for summary judgment. There, subordinated lenders to the firm of Pickard & Co., Incorporated alleged that the Exchange directly had participated in the negotiations leading to their investment because an Exchange vice president personally prevailed upon them to invest. (408 F.Supp. at 749, 751) The court declined to grant summary judgment until the lenders at least had an opportunity for discovery. (*id* at 751) Here, the record after trial shows that there was no communication between the Exchange and any plaintiff.

The other cases cited by plaintiffs, *Affiliated Ute Citizens* v. *United States,* 406 U.S. 128, *reh. denied,* 407 U.S. 916 (1972), *Superintendent of Insurance* v. *Bankers Life*

& Casualty Co., 404 U.S. 6 (1971), and *Herzfeld* v. *Laventhol, Krekstein, Horwath & Horwath*, 540 F.2d 27 (2d Cir. 1976), are similarly distinguishable. In each, the defendant was an active participant in the allegedly fraudulent transaction.

Here the Exchange simply directed at the January 29, 1969 meeting that McDonnell comply with Rule 325. (Ex. 74) McDonnell said it would comply immediately. (Vol. 6, Tr. 1985) McDonnell did not tell the Exchange how, and the Exchange never told McDonnell how it should obtain compliance. (Vol. 6, Tr. 1985-1986)

B. Plaintiffs had no disclosure claim under Section 6.

Section 6 is not a disclosure statute. It is an enforcement statute. No liability can arise unless an exchange knows or reasonably should have known of a violation by a member. In *Baird* v. *Franklin,* 141 F.2d 238 (2d Cir.), *cert. denied,* 323 U.S. 737 (1944), this Court defined the Section 6 duty to be one of enforcement *and not that of a fiduciary*: "We can see no substantial resemblance between the duties of bailees or other fiduciaries and those of the Stock Exchange." 141 F.2d at 239. *Accord: Steinberg* v. *Merrill Lynch, Pierce, Fenner & Smith,* CCH Fed.Sec.L.Rep. ¶ 94,599 (S.D.N.Y. 1974), and *Rich v. New York Stock Exchange,* 379 F.Supp. 1122 (S.D.N.Y. 1974), *reversed on other grounds and remanded,* 522 F.2d 153 (2d Cir. 1975).

In *Hochfelder* v. *Midwest Stock Exchange, supra,* the Court of Appeals for the Seventh Circuit gave the following analysis of the duty imposed by Section 6:

> "Although the section 6 duty of self-regulation is framed in broad language, 'to enforce so far as is within its powers', it is not a mandate of strict liability rendering the exchange a guarantor of all fraudulent schemes consummated by its members whether in listed or unlisted securities. To so read section 6 would tear at the very fabric of self-regulation, a burden which indeed no self-regulatory body could bear. The scope

of the duty of self-regulation is not so far reaching. Rather, the scope must be delineated to include only those acts, events, schemes, or circumstances surrounding exchange members of which the exchange knows or has reasonable cause to know, or those events and circumstances which would reasonably put the exchange on notice, of a violation or suspected violation of a securities law, regulation or rule or, exchange rule. It is only in the face of these circumstances that a failure to proceed with the requisite due care and conduct would be a dereliction of the duty of self-regulation." (503 F.2d at 367-68)

A similar standard was prescribed in *Rich* v. *New York Stock Exchange, supra,* where the district court said:

> "The Exchange's supervision need not be 'fluoroscopic', and liability should not be imposed on the Exchange merely because a violation of its rules escaped its detection. Hochfelder v. Midwest Stock Exchange, 350 F.Supp. 1122, 1125 (N.D. Ill. 1972). Liability should attach only if plaintiff demonstrates that the Exchange had reason to believe or suspect that a member firm was in violation of the rules, and then failed or refused to take remedial action, which failure to act resulted in an injury to the plaintiff. . . . No sheriff can prevent all felonies in his bailiwick, and the law does not so require." (379 F.Supp. at 1126) (citations omitted)

In its recent decision in *Hughes* v. *Dempsey-Tegeler & Co., Inc., supra,* the Court of Appeals for the Ninth Circuit concurred in the approach of the district court in *Rich.* (534 F.2d at 156).

Many courts have granted summary judgment for an exchange applying these standards. *E.g., Butterman* v. *Walston & Co.,* 387 F.2d 822 (7th Cir. 1967), *cert. denied,* 391 U.S. 913 (1968); *Hochfelder* v. *Midwest Stock Exchange, supra; Marbury Management, Inc.* v. *Alfred Kohn, Wood, Walker & Co.,* 373 F.Supp. 140 (S.D.N.Y. 1974);

Steinberg v. *Merrill Lynch, Pierce, Fenner & Smith, Inc., supra.*

As these decisions make clear, the fact that violations by Exchange members of rules or the Exchange Act may have occurred is of little moment in the absence of the three separate elements required by the above decisions, *i.e.*, that (1) the Exchange knew or had reason to know that its member was violating the rule or the Act, (2) failed thereafter to take action in respect of such violation, and (3) such failure to act proximately caused injury to plaintiff.

Since the uncontested evidence shows that the Exchange did not know of, or have reason to suspect, any fraudulent conduct by McDonnell in respect to plaintiffs' investments, it cannot be said that the Exchange knew or had reason to know of any violation by McDonell of its disclosure responsibilities.

III

The Trial Court's Evidentiary Rulings Were Well Within its Discretion

In challenging the trial court's evidentiary rulings, plaintiffs have misstated the issue. (Br. 4) The issue is not whether the trial court erred, but whether the trial court abused its discretion, and thereby denied plaintiffs substantial justice. Rule 61, Federal Rules of Civil Procedure.

The trial court has broad discretion to admit or exclude evidence on the ground of relevancy. *United States* v. *Araujo*, Docket Nos. 76-1085, 76-1086, 76-1150 (slip opin.) (2d Cir. July 26, 1976); *United States* v. *Harvey,* 526 F.2d 529, 536 (2d Cir. 1975), *cert. denied,* 424 U.S. 956 (1976); *Reynolds* v. *Pegler,* 223 F.2d 429, 435 (2d Cir.), *cert. denied,* 350 U.S. 846 (1955). Such a determination necessarily requires the balancing of intangible factors peculiarly within the knowledge of the trial judge. *United States* v. *Bowe,* 360 F.2d 1 (2d Cir.), *cert. denied,* 385 U.S. 961 (1966) and 385 U.S. 1042, *reh. den.,* 386 U.S. 969 (1967).

A. The trial court acted within its discretion in making evidentiary rulings regarding the SEC's supervision of McDonnell and the Exchange.

The trial court was within its discretion in 1) admitting evidence concerning the SEC's actual supervision of McDonnell and the SEC's oversight of the Exchange's regulation of McDonnell; and (2) excluding evidence which contained hindsight hearsay opinion of general regulatory conditions and policies. Furthermore, the court assured plaintiffs substantial justice when it prohibited the Exchange from arguing the issue of SEC oversight to the jury and refused to give the Exchange's requested instructions on this issue.

The SEC documentary evidence received dealt chiefly with contemporaneous communications among McDonnell, the SEC, and the Exchange concerning the financial and operational condition of McDonnell.[12] Much of this evidence was received without objection (Vol. 4, Tr. 1156-1157; Vol. 6, Tr. 1865-1868, Tr. 1872-1873, Tr. 1887-1889, Tr. 1897, Tr. 2022-2024, Tr. 2041-2043).[13] The evidence was probative not only as to the condition of McDonnell, but also as to the Exchange's knowledge of that condition. Plaintiffs first introduced similar evidence in the form of an SEC operations questionnaire completed by McDonnell (Ex. 34A), which was received and opened up the issue of SEC oversight of McDonnell.

The SEC evidence offered by plaintiffs and excluded differed markedly from the evidence offered by the Exchange. One segment sought to elicit the views of officers of the Exchange concerning the SEC's general opinion of the Exchange's regulation of member firms. Objection was

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[12] In addition, evidence was received concerning the regulatory powers of the SEC over the Exchange and Exchange member firms (see Vol. 6, Tr. 1880, 1887), which was relevant to set the context of supervised self-regulation under the Exchange Act.

[13] One item, a letter from the Exchange to the SEC concerning the condition of McDonnell, was objected to on the ground that it had not been produced at pretrial discovery. However, plaintiffs did not object on relevancy. (Vol. 6, Tr. 2022-2024)

properly sustained on grounds of hearsay, opinion or form. (Vol. 4, Tr. 1325-1326; Vol. 6, Tr. 2173-2174, 2178) Other evidence offered by plaintiffs were minutes of meetings between the SEC and the Exchange which did not relate to McDonnell. These were irrevalent. (Vol. 7, Tr. 2190-2191)

In great part, plaintiffs' proposed documentary evidence consisted of Congressional reports, SEC studies, and letters from the SEC to the Exchange setting out the SEC's opinion as to the general effectiveness of the Exchange's regulation of member firms. (Vol. 6, Tr. 2174-2180, Vol. 7, 2261-2263; Ex. 104 for identification, E-100; Ex. 105 for identification, E-227) With one exception, this evidence did not deal with the problems at McDonnell, and none was created contemporaneously with the events at issue.[14] Most importantly, such evidence was prejudicial, since it consisted solely of second-hand after-the-fact diatribes and opinions concerning general regulatory activities which obviously were designed to protect the position and point of view of the writer or his organization. Indeed, the introduction to the principal Congressional study proffered by plaintiffs contained the disclaimer that its general content was selective, incomplete, and admittedly of disputed accuracy. (Ex. 102 for identification; Vol. 4, Tr. 1263-1264)

Plaintiffs' proposed evidence was highly prejudicial, because it raised the inference that because the SEC had criticized the Exchange (after-the-fact) for its administration of certain rules in general, the Exchange in fact had administered its rules improperly in the case of McDonnell. The trial court has discretion to exclude evidence, even if otherwise admissible, when convinced that it will generate prejudice that outweighs its probative value, *Kilarjian* v. *Horvath,* 379 F.2d 547, 548 (2d Cir. 1967), or

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[14] One document, an SEC study of the Exchange's enforcement of its rules, contained one reference to McDonnell. However, this study suffered from the same infirmities—hearsay, hindsight, and opinion. (Vol. 7, Tr. 2261-2263)

when the evidence is only slightly probative and its introduction would confuse and mislead the jury by focusing its attention on collateral issues that would unnecessarily delay the trial. *Vareltzis* v. *Luckenbach Steamship Co., Inc.*, 258 F.2d 78, 81 (2d Cir. 1958); *United States* v. *Dennis*, 183 F.2d 201, 233 (2d Cir. 1950), *aff'd*, 341 U.S. 494 (1951); *Apicella* v. *McNeil Laboratories, Inc.*, 66 F.R.D. 78, 86 (E.D.N.Y. 1975).

Even assuming that plaintiffs' proposed evidence went to the same point as did that of the Exchange, this Court has held that the trial court does not abuse its discretion if it admits the evidence of one party while rejecting that of the other party when the excluded evidence does not measure up to the same standards as the evidence admitted. *United States* v. *Costello*, 221 F.2d 668, 674 (2d Cir. 1955), *aff'd* 350 U.S. 359, *reh. denied*, 351 U.S. 904 (1956).

The trial court leaned over backwards to remove any conceivable prejudice to plaintiffs when it withdrew the SEC oversight issue from the jury's consideration by refusing to give the SEC oversight charges requested by the Exchange and by prohibiting the Exchange from arguing the issue to the jury. The trial court has discretion in fashioning compromises on admission of evidence. See *Apicella* v. *McNeil Laboratories, Inc., supra*. The Exchange clearly was entitled to such a change. *Hughes* v. *Dempsey Tegeler & Co., Inc., supra*, at 534 F.2d 170-173; *Exchange Buffet Corp.* v. *New York Stock Exchange*, 244 F.2d 507, 510 (2d Cir. 1957). Plaintiffs' counsel consented to this compromise. (Vol. 7, Tr. 2335, 2351, 2356-2357) Although plaintiffs now claim that the SEC oversight issue was injected into the case by the introductory part of the charge to the jury (Br. 36), the challenged portion of the charge related to the general background and function of the Exchange and had nothing to do with the SEC's oversight of McDonnell. Furthermore, this part of the charge was not objected to by plaintiffs. Plaintiffs therefore cannot attack this compromise and the charge to the jury.

B. The trial court acted within its discretion in admitting evidence relevant to an understanding of the Exchange's regulation of McDonnell while excluding evidence which would have put the Exchange's supervision of other member firms on trial.

Much of the evidence which plaintiffs now attack was admitted without objection at trial. (Vol. 3, Tr. 977, 1976-1979; Vol. 4, Tr. 1238-1239; Vol. 6, Tr. 1901, 1967-1971, 2012-2012) Other evidence now challenged was offered by plaintiffs themselves. (Vol. 4, Tr. 1201-1203)

One segment of the evidence which plaintiffs attack gave a general background of Exchange regulatory procedures and normal practices and was relevant to aid in the jury's understanding of how they were applied to the situation at McDonnell. (Vol. 4, Tr. 1208; Vol. 6, Tr. 1905, 1967-1973, 2008-2009; Vol. 7, Tr. 2306-2310; Vol. 6, Tr. 1999-2003) Another section of the testimony, dealing with the large number of firms that had paperwork problems during the late 1960's, was elicited to show why the witness, an employee of the Exchange who had functioned with regard to many firms, had difficulty in recalling the details of his specific dealings with McDonnell. (Vol. 3, Tr. 974) Evidence concerning the Exchange's normal practices provided background for understanding how the Exchange applied its rules with regard to McDonnell. (Vol. 4, Tr. 1208; Vol. 6, Tr. 1905, 1967-1973, 2008-2009)

The trial court properly rejected plaintiffs' proffered evidence concerning specific details of the Exchange's regulation of specific member firms other than McDonnell. This evidence was irrelevant to the issue of whether the Exchange acted properly in regulating McDonnell. (Vol. 7, Tr. 2225-2238) Many of the questions concerning the Exchange's alleged failure to regulate during the 1968-1969 period were objectionable on the basis of form. (Vol. 6, Tr. 2165-2166, 2173-2174; Vol. 7, Tr. 2254-2256) Those questions which called for an opinion by the witness concerning the ease of regulating certain classes of firms were not relevant. (Vol. 7, Tr. 2250)

The magazine interview of Lee Arning, a former Exchange officer, concerned the Exchange's regulation of firms in general and was not relevant to the specific regulation of McDonnell. The various attempts of plaintiffs to get this evidence received foundered for lack of authentication, improper form, irrelevancy, and characterization. (Vol. 4, Tr. 1372-1383) Much of the evidence which plaintiffs claim was excluded erroneously was in fact offered by the Exchange (Vol. 3, Tr. 705-777, 804-806); that offered by plaintiffs was properly rejected because of improper form, lack of foundation, or calling for an opinion regarding the characterization of certain documents. (Vol. 3, Tr. 687-690, 784-785, 790-791, 807-809, 829-830)

Plaintiffs' proffered evidence was offered for no purpose other than to attempt to show that the Exchange had been deficient in its supervision of other firms, had been lax in its regulation in general, and therefore must have fallen short in its regulation of McDonnell. The trial court was clearly within its discretion in confining the evidence to McDonnell. See, *e.g.*, *United States* v. *Pacelli*, 521 F.2d 135, 138-140 (2d Cir. 1975), *cert. denied*, 424 U.S. 911 (1976); *United States* v. *Bowe*, *supra*, at 15-16.

C. The trial court acted within its discretion in admitting evidence showing plaintiffs' close family relationship to the principals of McDonnell.

Evidence concerning the relationship between plaintiff and defendant is relevant to assessing liability under the fraud provisions of the securities laws. *Robinson* v. *Cupples Container Co.*, 513 F.2d 1274, 1277 (9th Cir. 1975); *White* v. *Abrams*, 495 F.2d 724, 735-736 (9th Cir. 1974); *Rogen* v. *Ilikon Corp.*, 361 F.2d 260, 267-268 (1st Cir. 1966); *H. L. Federman & Co.* v. *Greenberg*, 405 F.Supp. 1332, 1336, 1338 n. 2 (S.D.N.Y. 1975). This principle applies to a family or close personal relationship. *Hilton* v. *Mumaw*, 522 F.2d 588, 596, 598 (9th Cir. 1975); *Jackson* v. *Bache & Co.*, 381 F.Supp. 71, 75-92 (N.D. Cal. 1974). Such evidence is relevant

to the issues of reliance, materiality, and causation under plaintiffs' Rule 10b-5 fraud claims, *Titan Group, Inc.* v. *Faggen*, 513 F.2d 234 (2d Cir.), *cert. denied*, 423 U.S. 840 (1975), and proximate cause under their Section 6 claims. *Baird* v. *Franklin, supra.*

There was considerable evidence showing that plaintiffs' motivation in investing in McDonnell was not profit but to do a favor for their relatives who ran the firm. Mrs. McDonnell testified that "Any child had what they wanted if I could give it to them, help them out." (Vol. 4, Tr. 1041) "As T. Murray McDonnell is my son, I agreed to subordinate my account at McDonnell in 1962 and 1965 and as was the case in 1969, to contribute to my already subordinated account." (Vol. 4, Tr. 1053) Mrs. Murphy testified that she agreed to subordinate her account as a favor to her brother Murray (Vol. 1, Tr. 147) and on trust in her family. (Vol. 1, Tr. 79-80). Evidence showing that the entire capital structure of McDonnell was made up of family money similarly is relevant. (Vol. 6, Tr. 1909-1910; Vol. 4, Tr. 1210-1211, Vol. 7, Tr. 2461)

The comments in the opening statement to the jury (Vol. 1, Tr. 14, 16), concerning the relationship of Henry Ford to McDonnell, were made in the context of remarks concerning other members of the McDonnell family and their mutual loyalty to the firm. The testimony concerning Mrs. McDonnell's use of her account at McDonnell for personal purposes illustrated the close ties between her and the firm (Vol. 4, Tr. 1046-1048; Vol. 5, Tr. 1744-1746); similarly relevant were the questions concerning the relationship of the plaintiffs to their father, the founder of McDonnell. (Vol. 1, Tr. 116-117)[15]

The questioning about Anne (McDonnell Ford) Johnson's marriage to Henry Ford, about which plain-

[15] It is particularly startling that plaintiffs object to the court's having received evidence on the connection of various McDonnell family members to McDonnell, when it was plaintiffs who insisted that the investment relationship to McDonnell of each and every of the fourteen McDonnell siblings be received as evidence. (Vol. 5, Tr. 1776-85)

tiffs complain, concerned nothing more than an attempt to identify her. Mrs. Johnson was a major capital contributor to McDonnell under her former name. Since Anne Johnson's name had been changed as a result of her remarriage, it was important that the jury not be confused. (Vol. 5, Tr. 1764-1765; Vol. 1, Tr. 22-24) Identification of Anne Johnson merely as "one of Mrs. McDonnell's daughters" would not have averted this confusion, for Mrs. McDonnell had eight daughters.

IV

The Trial Court Properly Denied Plaintiffs' Motions for a Directed Verdict or J.N.O.V. Against the Exchange

The standard to be applied in determining whether plaintiffs were entitled to a directed verdict or to a judgment notwithstanding the verdict ("j.n.o.v.") is

> "whether the evidence is such that, without weighing the credibility of the witnesses or otherwise considering the weight of the evidence, there can be but one conclusion as to the verdict that reasonable men could have reached." (citations omitted) *Simblest* v. *Maynard*, 427 F.2d 1, 4 (2d Cir. 1970)

See *Bernardini* v. *Rederi* A/B Saturnus, 512 F.2d 660, 622 (2d Cir. 1975).

To have been entitled to a judgment for a violation of Section 6, plaintiffs must have proved, to the extent that no reasonable person could differ, that the Exchange failed to regulate McDonnell reasonably and thereby proximately injured plaintiffs. The Exchange must be accorded substantial discretion and flexibility in interpreting and obtaining compliance with its rules in the public interest. *Intercontinental Industries, Inc.* v. *American Stock Exchange*, *Hughes* v. *Dempsey-Tegeler & Co., Inc.*, and *Rich* v. *New York Stock Exchange*, all *supra*.

The evidence shows that the Exchange acted reasonably. Upon learning of recordkeeping problems disclosed by the 1967 audit, the Exchange imposed a series of restrictions upon McDonnell in order to improve its recordkeeping. (Vol. 6, Tr. 1918-1919) Thereafter, under continuing Exchange surveillance, McDonnell imposed upon itself restrictions to curtail its paperwork problems. In January, 1969, the Exchange directed McDonnell promptly to bring itself back into capital compliance. One would be hard pressed to suggest an enforcement method more appropriate than a directive to comply immediately—which was fulfilled by McDonnell.

The Exchange reviewed carefully the voluntary restrictions under which McDonnell was operating in January 1969 and determined that those restrictions were the appropriate ones to permit McDonnell to cure its recordkeeping problems. (Vol. 6, Tr. 1974) In April, 1969, the Exchange requested and McDonnell supplied a work plan to help further resolve the operations problems. (Vol. 6, Tr. 2012) On May 21, 1969, when the recordkeeping and capital problems experienced by McDonnell became more acute, the Exchange added to the self-imposed restrictions under which the firm was operating. (Vol. 6, Tr. 2025-26)

During the fall of 1969, the Exchange approved a recapitalization plan and supervised while McDonnell strived to pare down the size of the firm to a New York operation centered around its historic rights specialty. Then, when notified on February 2, 1970 that Lybrand was unable to compute the firm's net capital ratio for its audit of December 19, 1969, the Exchange directed the firm to deliver out the remaining customer accounts and to liquidate. (Vol. 6, Tr. 2051-2055)

Even if there were no evidence in support of the Exchange's position that it acted reasonably in regulating McDonnell, plaintiffs would not be entitled to a judgment against the Exchange. Plaintiffs would have had to establish, as the trial court charged, that the Exchange's

failure to regulate proximately caused injury to them. *Baird* v. *Franklin, supra.* However, there was abundant evidence adduced at trial supporting the Exchange's contention that any alleged failure to regulate did not proximately injure plaintiffs. (See, *e.g.*, Vol. 2, Tr. 408-411, Ex. 3, Receiver's Ex. B-1)

V

Plaintiffs Lack Standing to Assert Claims Based on Section 6.

An independent and sufficient reason for upholding the dismissal of plaintiffs' Section 6 claims is that plaintiffs lack standing to assert them.[16] A cause of action against the Exchange for failure to enforce its net capital and record-keeping rules should be limited to that class which Congress intended to have the especial benefit of Exchange self-regulation of a member firm's operational and financial condition—public customers. If the Exchange must enforce such rules so as to prevent any loss to the capital of a member firm (which is derived in part from capital contributors such as plaintiffs), the protection afforded to the public which invests through member firms would be impaired.[17]

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[16] Prior to trial, the Exchange moved for summary judgment dismissing plaintiffs' Section 6 claims for lack of standing. (Vol. 1, xvii) The court reserved decision. The Exchange renewed the motion at trial (Vol. 5, Tr. 1477-1478), but it was never decided. Thus, the standing argument has been preserved.

[17] The issue of standing to sue under Section 6 is on appeal before this Court in Lank v. New York Stock Exchange, Docket No. 76-7243 (2d Cir. 1976). In that action Judge Lasker, on the basis of his decision in New York Stock Exchange, Inc. v. Sloan, 394 F.Supp. 1303 (S.D.N.Y. 1975), granted standing to sue to a receiver of a member corporation. But Judge Lasker then certified the question for appellate review under 28 U.S.C. § 1292(b), finding that there was substantial ground for difference of opinion. This Court accepted certification. The standing issue has also been argued by the Exchange in support of affirmance of the result below in Arneil v. Ramsey, Docket No. 76-7305 (2d Cir. 1976).

The Supreme Court recently has given guidance in *Cort v. Ash*, 422 U.S. 66 (1975), concerning the creation of private rights of action to enforce statutory duties on behalf of a protected class. The Supreme Court summarized the factors to be considered:

> "In determining whether a private remedy is implicit in a statute not expressly providing one, several factors are relevant. First, is the plaintiff 'one of the class for whose *especial* benefit the statute was enacted,' (emphasis supplied)—that is, does the statute create a federal right in favor of the plaintiff? Second, is there any indication of legislative intent, explicit or implicit, either to create such a remedy or to deny one? Third, is it consistent with the underlying purposes of the legislative scheme to imply such a remedy for the plaintiff? And finally, is the cause of action one traditionally relegated to state law, in an area basically the concern of the States, so that it would be inappropriate to infer a cause of action based solely on federal law?" (422 U.S. at 78) (citations omitted)

Under the rule of *Cort* v. *Ash,* only a public customer, *i.e.,* a person who invests through a brokerage firm, not a person who invests in a brokerage firm, has standing under Section 6. Public customers constitute the class for whose especial benefit the Exchange Act was enacted. The legislative history reveals no intent to create a remedy for the benefit of anyone other than public customers. Moreover, implying a right to sue on behalf of capital contributors of member firms would be inconsistent with regulation of the financial responsibility of member firms to protect the public customer—an underlying purpose of the Exchange Act.

In the first case implying a private right of action under Section 6, *Baird* v. *Franklin, supra,* Judge Clark, who dissented on the issue of causation, gave careful analysis to the legislative purpose and said:

> "[T]he Act was enacted for the benefit and protection of customers of members of registered exchanges and

of such members of the general public, including plaintiffs, as might carry on security transactions with members of a registered exchange . . . ." (141 F.2d at 242)

and:

> "One of the primary purposes of Congress in enacting the Securities Exchange Act of 1934 was to protect the general investing public." (141 F.2d at 244)

The legislative history bears out this analysis. *E.g.,* S. Rep. No. 792, 73d Cong., 2d Sess. 4 (1934) (the need for government intervention in securities regulation is to "afford protection to investors"); H.R.Rep. No. 1383, 73d Cong., 2d Sess. 2 (1934) (purpose of the Exchange Act is "to regulate the stock exchanges and the relationships of the investing public to corporations which invite public investment by listing on such exchanges."); 78 Cong. Rec. 2270-71 (1934) (remarks of Senator Fletcher) ("the interests of the general public are paramount" to those of insiders in stock exchanges and member firms). See also Section 6 of the Securities Investor Protection Act, 15 U.S.C. § 78fff(c)(2)(A)(iii), which defines "customer" to exclude persons who have claims for property which is part of the capital of a broker-dealer or is subordinated to claims of creditors of a broker-dealer; this provision of SIPA expressly amends the Exchange Act, 15 U.S.C. § 78bbb.

In *Sloan, supra* at n. 17, the district court recognized that "[t]here is no doubt that this [protection of public customers] was a primary purpose of the Act . . . ." Nevertheless, the court found that the Exchange Act had broad purposes and that

> "the requirements for standing should be flexible enough to take account of the nature and intent of the particular Exchange rule whose violation is the subject of suit." (394 F.Supp. at 1310)

In expanding the remedy implied in *Baird* to give capital contributors in member firms a right to sue the Ex-

change for the manner in which it enforced its net capital and recordkeeping rules, the *Sloan* court failed to recognize that it was not "consistent with the underlying purposes of the legislative scheme to imply such a remedy," as now required by *Cort* v. *Ash, supra.* Moreover, the *Sloan* court, in expanding the remedy, misapplied the flexible test which it had fashioned. The court assumed that public customers and capital contributors stood in the same relationship to the firm and to the Exchange with respect to net capital and recordkeeping rules since both "entrust their funds or securities to broker-dealers." 394 F.Supp. at 1310. The functions performed by these rules have different impacts on these two classes and consequently they cannot stand in the same relationship to the member firm or to the Exchange. Imposing a dualistic duty to enforce the net capital rule to protect both public customers and capital contributors would be inconsistent with the legislative purpose.

An analysis of the net capital rule shows that it was designed to protect customers who entrust cash or securities to member firms and not to protect capital contributors. Indeed, the funds of capital contributors to member firms are required for the protection of public customers. This is the primary function of the net capital rule, as recognized in *J. R. Williston & Beame, Inc.* v. *Haack*, 387 F.Supp. 173, 179 (S.D.N.Y. 1974), and *SEC* v. *General Securities Co.*, 216 F.Supp. 350, 351 (S.D.N.Y. 1963).

Affording the capital contributor standing to sue under Section 6 creates a conflict in duties which is inherent in the difference in status between customers and capital contributors. In *Carr* v. *New York Stock Exchange, Inc.*, 414 F.Supp. 1292, 1298 (N.D.Cal. 1976), the court said:

> "In enforcing its rules and in making complex decisions on the suspension or forced liquidation of members, the Exchange must consider the often conflicting interests of the member firm, its partners, and investors, and the corporations whose securities are handled by the firm, as well as the Exchange's public customers. Under these circumstances it cannot be

said, as plaintiffs here seem to contend, that complete suspension should automatically follow a firm's breach of Exchange rules."

There can be no doubt that the Congress would not countenance any attenuation of the protection of Section 6, which was intended to benefit the public customer, in favor of those who had opted to become capital contributors and thus an integral part of a member firm. Capital contributors in member firms are not members of the class for whose "*especial* benefit" the statute was enacted. *Cort* v. *Ash, supra.* Expansion of the remedy to include capital contributors is inconsistent with the purposes of the statute, since it does not further the purposes which the net capital and recordkeeping rules were designed to serve and limits the effectiveness of measures designed to enforce these rules.

Conclusion

The judgment of the district court should be affirmed.

November 8, 1976

Respectfully submitted,

MILBANK, TWEED, HADLEY & McCLOY
Attorneys for Defendant-Appellee
New York Stock Exchange, Inc.
1 Chase Manhattan Plaza
New York, New York 10005

Of Counsel:

RUSSELL E. BROOKS
TONI C. LICHSTEIN
WILLIAM C. OWENS, JR.

ADDENDUM

Operation of Member Organizations

Capital Requirements

(Rules and Policies Administered by the Department of Member Firms.)

Capital Requirements for Member Organizations and Individual Members

General provisions

Rule 325. (a) No member or member organization doing any business with others than members or member organizations or doing a general business with the public, except a member or member organization subject to supervision by State or Federal banking authorities, shall permit, in the ordinary course of business as a broker, his or its Aggregate Indebtedness to exceed 2000 per centum of his or its Net Capital, which Net Capital shall be not less than $50,000 in the case of a member organization carrying any accounts for customers and shall be not less than $25,000 in the case of any other member or member organization subject to this rule, unless a specific temporary exception is made by the Exchange in the case of a particular member or member organization due to unusual circumstances.

The initial Net Capital of a member corporation shall be at least 120% of the Net Capital required to be maintained by this rule.

The Exchange may at any time or from time to time in the case of a particular member or member organization prescribe greater requirements than those prescribed herein.

Each member or member organization shall promptly notify the Exchange if his or its Net Capital does not equal or exceed the minimum required by this rule.

Definitions

(b) For the purpose of this rule—

(1) The term "proprietary accounts" shall include capital accounts of partners or sole proprietor, investment and trading accounts, participations in joint accounts, accounts of partners which are covered by agreements, approved by the Exchange, providing for the inclusion of equities therein as partnership property and borrowings covered by subordination agreements approved by the Exchange;

(2) the term "aggregate indebtedness" shall include the total money liabilities of the member or member organization in all accounts other than customers' and brokers' accounts for commodity future contracts; plus equities in customers' and brokers' accounts for commodity future contracts; plus the market value of securities borrowed (other than for delivery against customers' sales) for which no equivalent value is paid or credited, exclusive of the following:

(A) money borrowed (adequately collateralized) on securities, spot commodities or other assets owned by the member, member firm or general partner thereof, or a member corporation and on those subordinated to general creditors;

(B) money payable against securities loaned which are owned by the member, member firm or general partner thereof, or a member corporation and those subordinated to general creditors;

(C) money payable against securities failed to receive in connection with transactions for the account of the member, member firm or general partner thereof, or a member corporation and for accounts subordinated to general creditors;

(D) money borrowings adequately collateralized by securities exempted from registration under the Securi-

ties and Exchange Act of 1934, otherwise than by action of the Securities and Exchange Commission;

(E) liabilities subordinated to general creditors pursuant to a separate agreement approved by the Exchange;

(F) equities in customers' commodity accounts segregated under the Commodity Exchange Act;

(G) equities in general partners' commodity accounts and credit balances in other accounts of general partners; and

(H) liabilities on open contractual commitments.

(3) The term "net worth" shall be the excess of total assets over total liabilities, after provision for current dividends declared and unpaid by a member corporation (except that credit balances and equities in "proprietary accounts" shall not be considered as liabilities) with securities, spot commodities, commodity future contracts in "proprietary accounts" and all other assets marked to market or fair value. A loss, at market, in an individual contractual commitment shall be deducted in determining Net Worth and a profit shall not be included. (See (c)(10) "Special Provisions" below.)

(4) the term "net capital" shall be Net Worth, less the following:

Debit Items

(A) Amounts included in Net Worth for:

(i) Memberships, furniture and fixtures, real estate and other fixed assets;

(ii) the value of securities which have no ready market;

(iii) unsecured loans and advances to partners and deficits in partners' accounts including those unsecured (see (c)(10) below);

(iv) deficits in customers' accounts including unsecured accounts and notes receivable (see (c)(9), (10) and (11) below); and

(v) prepaid rent, insurance and expenses and unsecured advances to employees and salesmen.

(vi) Debit balance in each customer's spot (cash) commodity account other than the result of a tender made on a futures contract within the past 90 days and evidenced by warehouse receipt(s) issued by a warehouse licensed by a commodity exchange. (See (c)(11) below.)

Long Positions

(B) 30% of the market value of securities and spot commodities long in "proprietary accounts" and in customers' accounts in deficit (10% of the market value of spot commodities if they are hedged). (See (c) Special Provisions below.)

Excess Short Positions

(C) The amount determined on the excess of the market value of short positions in securities over the market value of long positions in "proprietary accounts." The excess of the market value of short positions shall be determined separately for each percentage group set forth in this rule and in (c) "Special Provisions" thereof, except that bonds and stocks shall be considered separately. The amount of this debit item shall be 30% of the excess market value of short positions or the lesser percentage indicated in (c)(1) through (8) below. (See (c)(10) below.)

Commodity Futures—Proprietary Accounts

(D) 30% of the market value of all long and all short future commodity contracts (other than those

contracts representing spreads and straddles in the same commodity and those contracts offsetting or hedging any spot commodity positions) in "proprietary accounts."

Credit Lines

(E) Total of credit lines granted on open commodity contracts in "trade" accounts with net long positions or in "trade" accounts with net short positions, whichever is greater, plus any credit lines granted on open commodity contracts in "trade" accounts with no net long or net short position. (In computing the credit line granted in the case of each account, deduct the amount of the equity or the amount of the deficit therein, provided such amount is not in excess of the credit line granted, and the deficit, if any, is comprehended in other "Debit Items.") (See (c)(9) below.)

Commodity Futures—Customers' Accounts

(F)(i) Total amount by which the daily limit fluctuation of all future commodity contracts carried for a customer's account or accounts controlled by a customer exceeds 10% of the net worth of the member organization. Contracts in each customer's account representing purchases and sales of a like amount of the same commodity in the same market and in the same crop year may be eliminated. The daily limit fluctuations for future contracts effected in foreign markets is to be considered the same as if such contracts had been effected in a domestic market. (See (c)(11) below.)

(ii) 1½% of the market values of the greater of either the total long or total short future contracts in each commodity carried for all customers. Contracts in each customer's account representing purchases and sales of a like amount of the same commodity in the same market and in the same crop year may be eliminated. (See (c)(11) below.)

Cash Margin Deficiency

(G) Cash required to provide proper margin in customers' undermargined accounts in accordance with Rule 431 [¶ 2431]. (See (c)(9) and (11) below.)

(H) Cash required to provide margin equal to:

(i) the amount required to restore the original margin required by the pertinent commodity exchange or the clearing house requirement, per contract, whichever is greater, when the original margin has been depleted by 50% on all future commodity contracts in each customer's account. Cash required should be exclusive of liquidating deficits. (See (c)(9) and (11) below.)

(ii) 20% of the market value in each customer's account in equity containing spot commodity positions, evidenced by a warehouse receipt, issued by a warehouse licensed by a commodity exchange, which are the result of future contracts tendered through an exchange within the past 90 days, but not hedged by future contracts in the same commodity. (See (c)(9) and (11) below.)

(iii) 10% of the market value in each customer's combined account in equity when such account contains spot commodity positions, evidenced by a warehouse receipt issued by a warehouse licensed by a commodity exchange, which are the result of future contracts tendered through an exchange within the past 90 days, and hedged by future contracts in the same commodity. (See (c)(9) and (11) below.)

Other

(I) Any other amounts rightly to be comprehended as "Debit Items" in the computation of Net Capital.

Special provisions

U. S. Government and Municipal Bonds

(c)(1) In the case of obligations of:

(A) The United States or any agency thereof and obligations guaranteed as to principal or interest by the United States or any agency thereof the following percentages of market value shall be deducted:

(i) Less than one year to maturity	0%
(ii) One year but less than two years to maturity	1%
(iii) Two years but less than three years to maturity	1½%
(iv) Three years but less than four years to maturity	2%
(v) Four years but less than five years to maturity	2½%
(vi) Five years or more to maturity	3%

(B) A State, territory or possession of the United States or any political subdivision thereof and obligations guaranteed as to principal or interest by such State, territory, possession or political subdivision thereof, which are not in default as to interest, the following percentages of market value shall be deducted:

(i) Less than one year to maturity	0%
(ii) One year but less than two years to maturity	1%
(iii) Two years but less than three years to maturity	2%
(iv) Three years but less than five years to maturity	3%

(v) Five years or more to maturity:

a) covered by the 1st and 2nd ratings by any of the nationally known statistical services ---------- 4%

b) covered by the 3rd rating by any of the nationally known statistical services ---- 5%

c) covered by other ratings or not rated- 10%

(C) Any authority, commission or agency of a State, territory or possession of the United States or any political subdivision thereof which are payable as to principal and interest solely from specified revenues and which are not in default as to interest, the following percentages of market value shall be deducted:

(i) Less than one year to maturity ---- 1%

(ii) One year but less than two years to maturity ---------- 2%

(iii) Two years but less than three years to maturity ---------- 3%

(iv) Three years or more to maturity:

a) covered by the 1st and 2nd ratings by any of the nationally known statistical services ---------- 5%

b) covered by the 3rd rating by any of the nationally known statistical services ---- 7½%

c) covered by other ratings or not rated - 10%

Other Government Obligations

(2)—*Deleted—Included in (1) above, effective December 1, 1958.*

Redeemable Securities

(3) In the case of obligations or preferred stocks which the issuer has officially declared will be redeemed within

ninety days, the full market value or the cash redemption value, whichever is lower, shall be included in computing Net Worth and Net Capital.

Preferred Stocks

(4) In the case of preferred stocks (other than those above) on the "exempt" list shown in the NYSE GUIDE and senior nonconvertible preferred stocks of issuers whose interest bearing obligations are covered by the first three ratings by any of the nationally known statistical services, 20% of the market value shall be deducted.

Non-Convertible Bonds

(5) In the case of interest bearing obligations which do not have a conversion or exchange feature, covered by the first four ratings by any of the nationally known statistical services, the following percentages of market value shall be deducted: First rating—5%; second and third ratings—10%; fourth rating—15%, except that, in the case of such obligations having five years or less to maturity, covered by the first three ratings, the following percentages of market value shall be deducted: Maturity one year or less—1% ,two years—2%, three years—3%, four years—4% and five years—5%.

Convertible Bonds

(6) Interest bearing obligations which have a conversion or exchange feature and which are covered by the first four ratings by any of the nationally known statistical services, may be included in the computation of Net Capital at the lower of 100% of the principal amount or the market value less the applicable percentage designated for bonds which do not have a conversion or exchange feature.

Exchangeable Securities

(7) In the case of securities which are exchangeable or convertible, a security sold shall be considered, in computing Net Worth, as a sale of a security held, after adjust-

ment of the cost or proceeds of such securities for any money to be paid or received in connection with such exchange or conversion provided the security held is, without restriction other than the payment of money, exchangeable or convertible into the security sold within a period not exceeding thirty days. With respect to a case involving a longer period of time, the Department of Member Firms will consider a written application for permission to deduct a percentage of the proceeds of sale (in lieu of 30% or some other percentage of the market value of the security held).

Preferential Treatment Upon Application

(8) In the case of securities coming within the scope of any of the following clauses, the Department of Member Firms will consider a written application for permission to deduct a lesser percentage of the market value than heretofore provided.

(A) Interest bearing obligations and serial equipment trust certificates which are to be the subject of a primary distribution but for which a published rating is not yet available;

(B) obligations of any authority, commission or agency of a State, territory or possession of the United States or any political subdivision thereof which are payable as to principal and interest solely from specified revenues and which are not in default as to interest, which have less than nine months to maturity.

(C) obligations of a State, territory or possession of the United States or any political subdivision thereof or any authority, commission or agency thereof which are not rated by any of the nationally known statistical services.

Exclusion

(9) Exclusive of bona fide cash transactions for customers in issued securities and after application of current outstanding calls for margin, marks or other deposits.

Contractual Commitments

(10) Net Worth and "Debit Items" (A)(iii), (A)(iv), (B) and (C) of paragraph (b)(4) of Rule 325 should be adjusted for open contractual commitments which will include delayed delivery, underwriting and "when issued" contracts, endorsements of puts and calls and commitments in foreign currencies and spot (cash) commodity contracts but will not include open commodity future contracts and uncleared regular way purchases and sales of securities, by applying the amounts due thereon and any valuation of securities involved as though such amounts and valuations were actual, except that this treatment of any individual commitment shall not operate to increase Net Worth or Net Capital. A series of contracts of purchase or a series of contracts of sale, of a stated amount of the same security conditioned, if at all, only upon issuance shall be treated as an individual commitment and the profit, at market, in each individual commitment used to reduce the debit item (B) or (C) relating to that commitment.

Accounts Not Covered By Agreements

(11) Accounts of partners which are not covered by agreements, in form approved by the Exchange, providing that the securities and equities therein are to be included as partnership property, accounts of officers and accounts of holders of stock of a member corporation shall be considered as customers' accounts.

Securities Subject to Special Initial Margin Requirements

(12) In the case of member organizations whose trading shows a pattern of purchasing and selling the same listed stock on the same day, (or all member organizations when so designated by the Exchange), during the period in which any special margin requirement is in effect, the capital charge against any new proprietary transaction of members or member organizations pursuant to Rule 325 (Capital Requirements) resulting in a long or short position, shall be treated as a "contractual commitment" from the trade

date to the settlement date and shall be subject to a charge to net capital of the same percentage as specified in the special margin requirement, excepting in the case of the specialist in that stock or of others who at the request of a Floor Official have participated in a difficult market situation.

Amendments

Rule 325(c)(1), (2) and (8)(B) amended October 16, 1958, effective December 1, 1958.

Rule 325(b)(4) amended March 19, 1964, effective May 1, 1964.

Rule 325(c)(12) added October 28, 1965; amended January 20, 1966.

• • • ***Supplementary Material:***

.10 Computation of net capital under Rule 325.—

Credits:

(1)	Credit balances in accounts for Capital stock	$
(2)	Net credit balances in accounts for surplus and undivided profits (after provision, in the case of a corporation, for current dividends declared and unpaid)	
(3)	Credit balances in "proprietary accounts"	
(4)	Net profits, at market, in future commodity Exchange contracts carried for "proprietary accounts"	
(5)	Market value (or value indicated by accompanying instructions) of securities and spot commodities long in "proprietary accounts"	
(6)	Reserves (other than liability reserves) which are available as capital	
(7)	Total credits	$

Debits:

(8) Surplus deficit and undivided loses ---- $--------

(9) Debit balances in "proprietary accounts" -------------------------- --------

(10) Deficits in customers' accounts (other than bona fide cash accounts) after application of current outstanding calls for margin, marks or other deposits --- --------

(11) Market value of securities short in "proprietary accounts" ------------------ --------

(12) Net losses, at market, in future commodity Exchange contracts carried for "proprietary accounts" ------------- --------

[Net worth is equal to total of credits (1) through (6) (*i. e.*, item (7)), less total of debits (8) through (12) -- $--]

(13) Debit balances in accounts for fixed assets, prepaid items etc. such as:

Memberships -----------	$--------
Furniture, fixtures & Equipment -------------	--------
Prepaid expenses -------	--------
Profits and commissions receivable from syndicates ------------	--------
Real estate (See Instruction 10) -------------	--------
Miscellaneous advances and receivables -------	--------
Dividends receivable—non-current (See Instruction 8) --------	--------
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Total of Item (13) ------------- $--------

(14) 30% (or pertinent percentage of market values indicated in Rule 325 [¶ 2325] or (c)(1) through (8) thereof or as indicated in the accompanying instructions) of the market values of all securities and spot commodities long in "proprietary accounts" and in customers' accounts in deficit (other than bona fide cash accounts and after application of current outstanding calls for margin, marks or other deposits):

Market values etc.	*Percentage charge*	*Amount of charge*
$--------	30%	$--------
--------	20	--------
--------	15	--------
--------	10	--------
--------		--------
--------		--------
--------		--------
--------		--------
--------		--------
--------		--------
--------		--------

Total Amount of Charge -------------- $--------

(15) The amount determined on the excess of the market value of short positions in securities over the market value of long positions in "proprietary accounts" (See Debit Item (C) Rule 325 [¶ 2325]. See also Instruction 23 at .15, below.) ------------------------------ $--------

(16) 30% of the market value of all long and all short future commodity contracts (other than those representing spreads or straddles in the same commodity or

hedging any spot commodity positions) carried for "proprietary accounts" ___ $________

(17) Total of credit lines granted (See Instruction 24) ______________________ $________

(18)(a) Total of amount by which the daily limit fluctuation of all future commodity contracts carried for a customer's account or accounts controlled by a customer exceeds 10% of the net worth of the member organization. (See Instruction (25)(a)) ________________________ ________

(b) 1½% of market values of total long or total short future contracts in each commodity. (See Instruction (25)(b)) ______________________ ________

(19) Cash required to provide margin in accordance with Rule 431 [¶ 2431] after application of current outstanding calls for margin, marks or other deposits___ ________

(20)(a) Debit balance in each customer's spot (cash) commodity account other than the result of a tender made on a futures contract within the past 90 days and evidenced by warehouse receipt(s) issued by a warehouse licensed by a commodity exchange ________

(b) Cash required to provide margin in customers' commodity accounts in accordance with Rule 325 (b)(4)(H) after application of current outstanding calls for margin _________ ________

(21) Total Debits ________________________ $________

(22) Net Capital (item 7 less item 21) ____ $________

(23) Aggregate Indebtedness per Rule 325 [¶ 2325], Section (b)(2):

Total liabilities per Section (b)(2) ________________________ $______

Less exclusions per Section (b)(2)

(a) ____________ $______

(b) ____________ ______

(c) ____________ ______

(d) ____________ ______

(e) ____________ ______

(f) ____________ ______

(g) ____________ ______

(h) ____________ ______

Total exclusions ___________ ______

Aggregate Indebtedness ___ $______

(24) Minimum capital required to be maintained or 1/20th of item 23, whichever greater ____________________________ $________

(25) Net Capital in excess of minimum requirements (item 22 less item 24) _____ $________

(26) Ratio of Aggregate Indebtedness to Net Capital (item 23 divided by item 22) __ %

Instructions

.15 General.—

(1) Questions as to the computation of Net Capital or the treatment of items entering into such computation should be directed to the Department of Member Firms or phone HAnover 2-4200, extensions 325 or 326.

(2) The term "proprietary accounts" includes capital accounts of partners or sole proprietor, investment and

trading accounts, participations in joint accounts, accounts of partners which are covered by agreements, approved by the Exchange, providing for the inclusion of equities therein as partnership property and borrowings covered by subordination agreements approved by the Exchange.

(3) Individual accounts of limited and general partners of a member firm which are not covered by "equities" agreements approved by the Exchange and those of holders of stock of a member corporation shall be considered as customers' accounts. However, equities in general partners' commodity accounts and credit balances in other accounts of general partners shall not be included in Aggregate Indebtedness.

(4) If a limited partner contributes securities as capital and the partnership agreement limits his liability to an amount other than the market value thereof, enter in item (3) the lower of the amount to which his liability is limited or the market value reduced by the percentage to be deducted in accordance with ¶ 2325(c)(1) through (8). Do not include the value of such securities in item (5) or (14).

(5) Any borrowing for capital purposes which has not been approved by the Exchange, shall not be considered as a credit in computing Net Capital.

(6) Shares of the Board of Trade Clearing Corporation (Chicago) shall be considered as a current asset at the amount for which they can be sold to the Clearing Corporation. The excess of such amount over the ledger balance in the account for such shares shall be included in item (3). Any excess of the ledger balance over the current value shall be included as a debit in item (9).

(7) Cash surrender value of life insurance policies, which have been approved by the Exchange or which, in the opinion of firm's counsel, meet the requirements of the Exchange, shall be considered as a current asset. Any excess of such cash surrender value over the ledger balance shall be included as a credit in item (3). Any excess of the

ledger balance over the cash surrender value shall be included as a debit in item (9).

(8) Dividends receivable recorded after the ex-dividend date shall be considered as a current asset unless they represent claims which are not readily collectible.

(9) Good faith deposits on commitments in securities shall also be considered as a current asset.

(10) The debit balance for Real Estate shown in item (13) may not be reduced by the amount of mortgages thereon unless such procedure has been approved by the Department of Member Firms.

(11) If non-exempt securities of customers are pledged against a borrowing of "Exempt" securities, the market value of the securities borrowed shall be included in Aggregate Indebtedness.

(12) Unrecorded assets and liabilities, other than contractual and contingent items, should be treated as though recorded when computing Net Capital and Aggregate Indebtedness. Consideration should also be given to sufficiency of liability reserves in connection with any lawsuits pending, accommodation endorsements, rediscounted notes, guarantees or any other contingent liability.

Long and short positions, endorsed puts and calls—proprietary accounts

(13) If a firm does no business with others than members or member organizations, the market value of all readily marketable securities in "proprietary accounts" shall be included in items (5) and (14). The percentage charge and amount of charge in items (14) and (15) shall be zero.

(14) In the case of long securities which have no ready market, no value should be included in items (5) or (14).

(15) In the case of obligations or preferred stocks which the issuer has officially declared will be redeemed within 90

days, enter in item (5) the full market value or the cash redemption value, whichever is lower. Do not enter in item (14).

(16) In the case of interest bearing obligations having a conversion or exchange feature which are covered by the first four ratings by any of the nationally known statistical services, include the market value thereof in item (5) and item (14). Include in item (14) as the "Amount of charge," the excess of market value included in item (5), over the principal amount or over the market value less the applicable percentage for bonds which do not have a conversion or exchange feature, whichever amount is greater. For example, if convertible bonds with maturities exceeding five years have a second rating, the "Amount of charge" would be determined as follows:

(A)	Market value included in item (5)		$115,000
(B)	Principal amount	$100,000	
(C)	Market value $115,000 less 10% for second rating	103,500	
	Lower of (B) or (C)		100,000
	Amount of charge item (14)		$ 15,000

(A)	Market value included in item (5)		$105,000
(B)	Principal amount	$100,000	
(C)	Market value $105,000 less 10% for second rating	94,500	
	Lower of (B) or (C)		94,500
	Amount of charge item (14)		$ 10,500

On convertible bonds selling at 142⅞ or over, the maximum "Amount of charge" in item (14) will be 30% of market value as Rule 325 [¶ 2325] does not require a charge in excess of 30% of the market value of readily marketable securities.

(17) In the case of securities which are exchangeable or convertible, a security sold may be considered as a sale of a security held, after adjustment of the cost or proceeds of such security for any money to be paid or received in connection with such exchange or conversion, provided the security held is, without restriction other than the payment of money, exchangeable or convertible into a security sold within a period not exceeding 30 days. The proceeds of such securities, after adjustment, should be included in item (3) or used to reduce the debit in item (9). If the period exceeds 30 days and the Department of Member Firms has granted permission to include a percentage of the proceeds of sale, only the amount determined in accordance with such percentage, reduced by any amounts to be paid or increased by any amounts to be received in connection with such exchange or conversion, shall be included in item (3) or used to reduce the debit in item (9). Do not include the market value of the long securities in item (5) or the market value of securities sold in item (11).

(18) If the Department of Member Firms has, upon written application, granted permission to deduct a lesser percentage of the market value of a security than the percentage specifically provided by Rule 325 [¶ 2325], include the market value of such securities in item (5). Also include the market value in item (14), the percentage charge and the amount of charge.

(19) In the case of a long security against which the firm has sold a call and bought a put endorsed by a member firm (conversion account), such security shall be valued at the lower of the put or call price in lieu of the market price and such value included in item (5). Such value shall also be included in item (14) and 15% thereof shall be included in the amount of charge.

(20) If a call has been sold against a security held for "proprietary accounts" the market value of the security shall be included in items (5) and (14). The amount of charge in item (14) should be at 30% (or pertinent per-

centage) *provided* the contract amount of the call is greater than 70% (or pertinent percentage) of the market value. If the contract amount of the call is less than 70% (or pertinent percentage) of the market value then the excess of the latter over the contract amount should be included in item (9).

(21) If a put has been sold against a short position in "proprietary accounts" the excess of the contract value over the market value shall be included in item (9).

(22) Where a put or a call has been endorsed and there is no offsetting security position, each such put or call shall be considered separately. The contract value of a put shall be included in item (9). The market value of the securities represented by the put shall be included in item (5). The market value and the amount of charge based on the pertinent percentage should be included in item (14). If the market value included as a credit in item (5) exceeds the debit included in item (9) plus the amount of charge included in item (14), such excess shall be included as a debit in item (9). In the case of a call, the amount by which the market value exceeds the contract value shall be included in item (9). However, if a put and a call have been sold for the same number of shares of the same security, only the option resulting in the greater reduction in Net Capital should be considered as a contractual commitment.

(23) The amount required by item (15), relates to "excess" short positions in securities in "proprietary accounts" and is determined in the following manner:

The actual positions long and short in such accounts are adjusted for open contractual commitments. There should be eliminated from the resulting long and short positions:

(A) All long and short positions, actual and contractual, bonds and stocks, which will be cleared by eventual conversion of such long securities for delivery of such securities sold;

(B) long positions and all puts and calls in "conversion" accounts where a security is purchased, a

call is sold and a put is held which has been endorsed by a member firm;

(C) short positions and all puts and calls in "conversion" accounts where a security is sold, a put is sold and a call is held which has been endorsed by a member firm;

(D) long positions and calls where a security is held and a call has been sold.

(E) a put and a call sold for the same number of shares of the same security.

Also, in regard to item (15), a put sold by the firm should not be used to eliminate a short position nor should the put be considered as a long position.

A put or call owned by the firm should be disregarded for the purpose of determining long or short positions.

After the above eliminations have been made for the purpose of item (15), the valuations of long and short positions should be determined separately for stocks and for bonds and separately for each percentage category.

The market value of longs in a category is compared with the market value of shorts in that category for purposes of item (15). In each category where the short values exceed the long values, a charge results based on the percentage charge in that category applied to the excess short value. An example follows:

Category		*— Market Values —* *Long*	*Short*	*Short Excess*	*Amount of Charge*
Common and Pfd. Stocks	30%	$100,000	$120,000	$20,000	$6,000
Preferred Stocks ----	20%	30,000	—	—	—
Bonds --------	30%	50,000	—	—	—
Bonds --------	15%	10,000	15,000	5,000	750
Bonds --------	10%	100,000	—	—	—
Bonds --------	5%	50,000	—	—	—
Bonds --------	2%	—	50,000	50,000	1,000
Total Debit, Item (15) ----------------------					$7,750

The excess long values in a category should not be used to offset excess short values in another category.

The above relates only to charges on "excess" short positions in the accounts covered by item (15). It does not affect the charges on long positions in such accounts or the determination of any other debit item or credit item.

"Customers' Commodity Account Charges"

(24) The amount required by item (17), total of credit lines granted, is determined by multiplying the number of contracts in an account, on which credit has been granted, by the amount of credit granted on each such open contract. From the amount so determined, deduct the equity or deficit in that account (after application of current outstanding margin calls). The deduction, however, cannot exceed the amount of credit granted.

After the amount of credit granted has been determined for each customer's account, the amounts are totalled for accounts which have net long positions and separately for accounts which have net short positions. The amount required by the accounts with net longs or with net shorts, whichever amount is greater, is used. To this amount is added the amount determined for accounts with no net positions.

If an account has open positions in only one commodity, the number of contracts determines the net position. If it has a net long position in one commodity and a net short position in a different commodity, the market value determines the net position.

(25)(a) The amount by which the daily limit fluctuations of all future commodity contracts carried for a customer's account exceed 10% of the net worth of the member organization may be determined by eliminating from each customer's account or group of accounts controlled by a customer, purchases of a commodity in one contract month and sales of the same commodity in a different contract

month provided such contracts are in the same crop year and were made in the same market.

After such eliminations, the remaining number of contracts long and short is multiplied by the amount of the daily limit fluctuation prescribed by the pertinent commodity exchange for each contract in the respective commodity.

The total of the amounts determined for each commodity, in a customer's account or group of accounts controlled by a customer, is then compared with an amount equal to 10% of the net worth of the member organization. (The net worth at the end of a month or accounting period may be used for the succeeding month or accounting period not to exceed five weeks). The amount of the charge is the excess of the amount of the daily limit fluctuation over 10% of the net worth as in the following example:

Account of John Smith

	Number of Contracts Long	*Number of Contracts Short*	*Daily Limit Fluctuation Per Contract*	*Total*
Cocoa	1,000		$ 300	$ 300,000
Cotton*	100	100	1,000	200,000
Soybean Oil	500		600	300,000
Sugar	300		560	168,000
Wheat	300		500	150,000
				$1,118,000
10% of $10,000,000—Net Worth				$1,000,000
Amount of Charge				$ 118,000

*Straddle not in same crop year. The customer's equity in this account is not considered for the purpose of computing the amount of this charge.

(25) (b) The amount required by (18) (b), 1½% of market values of the total long or total short future contracts in each commodity, may be determined by eliminating from each customer's account purchases of a commodity in one contract month and sales of the same commodity in a different contract month provided such contracts were made in the same market and in the same crop year.

After such eliminations, the total market values of the remaining contracts long and short in all customers' accounts are determined separately for each commodity. The greater of the long value or short value of each commodity enters into the computation of 1½% as in the following example:

	Market Value		
	Long	*Short*	*Greater of Long or Short*
Coffee	$ 200,000	$ 100,000	$ 200,000
Cotton	1,500,000	1,000,000	1,500,000
Sugar	300,000	200,000	300,000
Corn	500,000	700,000	700,000
Oats	150,000	150,000	150,000
Wheat	1,000,000	1,300,000	1,300,000
			$4,150,000
Amount Required, 1½% of Total			$ 62,250

Contractual Commitments

For Proprietary accounts and customers' accounts in deficit

(26) Debit and credit items shall be adjusted for contractual commitments other than uncleared regular way purchases and sales of securities.

(27) A position in each security shall be considered as actual. The net cost of a long position should be included

in item (9). The market value of a net long position should be included in item (5). Such market value and the amount of charge based on the pertinent percentage should be included in item (14). If the market value included as a credit in item (5) exceeds the debit included in item (9) plus the amount of charge included in item (14), such excess shall also be included as a debit in item (9). Where no position exists, any loss should be included in item (9) and any profit disregarded. In the case of a short position any excess of the short position, at market, over the net proceeds should be included in item (9) and any profit, at market, disregarded.

If when issued transactions will be consummated within 30 days, they may be considered as actual without restriction.

Spot (cash) commodities contracts

(28) A position in each commodity shall be considered as actual and treated the same as when issued contracts. Net sales should be considered as hedges of any spot position in the same commodity which is included in item (14).

Commitments in foreign currencies

(29) Any loss, at market, in each foreign currency shall be included as a debit in item (9). Any profit, at market, shall be disregarded.

Joint trading and investment accounts in which the firm participates

(30) Include firm's portion of debit or credit balance (without adjustment for any deposit) in item (9) or item (3) respectively. Include its portion of short position, at market, in item (11). Include in item (5) its portion of the market value of long securities. Such market value of long securities and the amount of charge at the pertinent percentage should be included in item (14). Any margin deposit is not to be included as a debit in computing capital.

Joint foreign and domestic arbitrage accounts in which the firm participates

(31) Money balances and securities positions carried by the firm and by a participant may be combined and considered on a net basis (off-setting positions in the same security may be eliminated). Adjustments may be made where different clearance dates apply to transactions made on the same day in the same security.

Include firm's portion of net debit or credit balance in item (9) or item (3) respectively. Include its portion of short positions, at market, in item (11). Include in item (14) its portion of the market value of long securities and the amount of charge at the pertinent percentage. Do not include, in item (19), any cash margin deficiency in connection with the participant's share of such account carried by the firm.

Information Regarding Capital Requirements

.16 Applications for higher percentage treatment. — Applications under .10 of Rule 325 [¶ 2325] should be submitted in writing to the Department of Member Firms. Such applications, in addition to clearly reciting the nature of the request for higher percentage treatment, should include the following information:

(1) Complete description of the security, including the number of shares of stock or principal amount of bonds involved;

(2) statement as to whether the shares of stock or principal amount of bonds are presently reflected in proprietary accounts. If not, an indication should be made as to the date on which the security is to be purchased or on which there will be a contingent commitment to purchase; and

(3) the rating assigned the security by a nationally-known statistical service and the name of such statistical service. If a rating is not available, it should be so stated.

.17 General partners' securities and equities in computation of net capital.—No securities and equities in partners' individual accounts will be included as partnership property in computing the Net Capital of a member firm unless the partnership articles of the firm or some supplemental agreement specifically provide for such inclusion.

The phraseology of such provisions will necessarily vary as between different firms and therefore no standard form has been prescribed. However, a suggested form, containing the essential features of such provisions may be obtained from the Division of Documents, Department of Member Firms. Member firms are particularly cautioned to consider this suggested form merely as a guide and to consult their own counsel before adopting it or any other form of agreement, since substantial rights of the firm and of the individual partners may be affected. Before adopting any particular wording, member firms are urged to submit their proposed form of agreement to the Division of Documents, Department of Member Firms, in order to ascertain whether or not it is satisfactory from the Exchange's point of view.

If the partnership articles or supplemental agreement merely subordinates the claim of a partner to the claims of creditors of the partnership arising out of any matters occurring before the partner ceases to be a partner in the firm, the Exchange, in the event of the death of such partner, will immediately upon his death have to disallow the securities and equities in the partner's individual accounts in computing the firm's Net Capital. If the partner desires to have such equities and securities treated as firm capital after his death the agreement which is in effect at his death must specifically provide that the securities and equities in his account at the time of his death are to continue as capital of the firm at the risk of the business for a stated period of time after his death and all claims of the estate of the deceased partner must be subordinated to the claims of all present and future creditors of the firm arising out of any matters occurring prior to the end of the stated period.

.15 Deceased or withdrawing partner's interest in continuing firms.—

I.

Where the partnership articles of a member firm do not include specific and legally adequate provisions to the effect that the claim of the personal representative of a deceased partner to the partner's interest in the firm shall be subordinated to the claims of all present or future creditors of the continuing firm (or any successor firm) arising out of matters occurring subsequent to the partner's death, the Exchange cannot, upon the partner's death, regard his interest as continuing to be part of the Net Capital of the continuing or successor firm.

Provisions in a deceased partner's Will permitting executors to continue a partner's capital interest at the risk of the business should not be relied upon as being effective immediately upon the partner's death, inasmuch as such provisions cannot, in any event, be availed of for a considerable period thereafter. Unless there are appropriate provisions in the partnership articles subjecting such capital to the risk of the business during the interim, the Exchange upon the partner's death cannot treat his interest as part of the firm's Net Capital. In many cases such a situation might render it necessary for the continuing firm to find additional capital immediately upon the death of the partner in order to meet the Exchange's capital requirements.

While the inclusion in the partnership articles of provisions continuing a deceased partner's interest at the risk of the business after his death is a matter to be determined in every case by the wishes of the partners, if it is the desire and intention of the partners of any firm that the interest of a deceased partner shall be considered, without interruption after his death, as a part of the capital of the continuing or successor firm for a specified period, the partnership articles should effectively provide in substance:

(1) That the payment of the deceased partner's interest in the firm to his estate be deferred for a stated period; and

(2) that until such payment, the interest of the deceased partner shall remain at the risk of the business of the continuing or successor firm and shall be considered as capital of such firm in the same manner and to the same extent as capital contributed by a limited partner; and

(3) that any claim of the personal representative of the deceased partner to such interest shall be subordinated in right of payment and subject to the prior payment or provision for payment in full of claims of all present and future creditors of the continuing firm (and any successor firm) arising out of any matters occurring before the end of the stated period.

If the partnership articles provide that such provisions are not effective unless affirmatively consented to by the personal representative of the deceased partner or if the personal representative is given the right, either to withdraw the capital or to terminate the continuing or successor firm before the end of the stated period, the deceased partner's capital can not be allowed by the Exchange in computing the firm's net capital after the date when the personal representative's consent is required or when the withdrawal of the capital or termination of the firm may be made effective except as follows: If the partnership articles give the personal representative the right to withdraw the capital prior to the end of the period during which it is otherwise kept at the risk of the business, all of such capital will not necessarily be disallowed by the Exchange from and after the date when such withdrawal might be effected, if the following additional conditions exist:

(1) The right to give notice (which may not be less than on 30 days) of a future withdrawal of capital may not accrue prior to the expiration of at least three months following the date of the personal representative's appointment.

(2) The personal representative shortly prior to the time when he may first give notice of withdrawal (whether

he intends to give such notice or not) should submit to the Exchange an affidavit setting forth the known and estimated liabilities of the estate (including taxes), the estimated value of the estate's assets, a statement showing whether any income tax returns of the decedent have not yet been audited by the tax authorities and a statement that to the best of his knowledge and belief, the decedent made no gifts during his lifetime which might be construed as being subject to estate or inheritance taxes, and the Exchange must be satisfied that the indications are that the estate will prove solvent.

(3) The Will of the deceased partner must contain specific affirmative authority to the personal representative to leave the deceased's capital in the firm in the executor's discretion, notwithstanding his option of withdrawing it.

(4) The representative and the firm should both undertake to advise the Exchange promptly upon discovery that there appears to be any substantial increase in the estate's liabilities or decrease in its assets as compared with the figures given in the affidavit which might indicate a greater possibility than theretofore of estate insolvency.

Even if all of the foregoing conditions are fully met, a right of withdrawal in the personal representative will necessitate disallowance by the Exchange of the deceased partner's capital if one or more of the representatives of the deceased partner is also a partner in the firm. In any case, the Exchange reserves the right, in its sole discretion, to disallow the deceased partner's capital at any time.

In drafting provisions for inclusion in partnership articles, it should be borne in mind that if the partnership has a stated termination date and the capital of a deceased partner is placed at the risk of the business until the end of the partnership term, the death of a partner near the end of the term might necessitate a disallowance by the Exchange of his capital interest within a very short time. In order to avoid this difficulty, it may be desirable to make appropriate provision for the continuation of the capital

at the risk of the business of a successor firm for a further stated period after the termination of the firm of which the deceased partner was a member.

If the surviving partners (rather than the personal representatives of the deceased partner) are to be given the right to elect whether or not the capital of a deceased partner is to be continued at the risk of the business of a continuing or successor firm, it may be desirable to provide that the capital is left absolutely at the risk of the business for a specified period, with the right in the surviving partners, prior to the expiration of such period, to elect to continue it for a longer time. Such a provision should obviate the necessity of making such an election immediately upon the death of the partner. If any of the surviving partners are also executors or administrators of the deceased partner the Exchange may not, for capital purposes, be able to give effect to such election.

If it is the desire of the partners to have a deceased partner's capital continued for a stated period immediately following his death, with the option in his personal representatives (rather than the partners) to continue it for a longer period under the provisions of the deceased partner's Will, it is suggested that the stated period in the partnership agreement be made sufficiently long so as to permit the conditions discussed below with respect to testamentary provisions to be complied with.

II.

With respect to provisions in a deceased partner's Will (as distinguished from those in a partnership agreement) providing that the personal representative shall or may become a limited partner in the firm or subordinate the claim of the estate to decedent's interest to the claims of firm creditor's who become such after the decedent's death, the Exchange's determination whether or not to allow a deceased partner's capital interest in computing the Net Capital of the firm will depend on the facts and circumstances of each

case as they exist at the time of such determination. However, in no case will such testamentary provisions be considered as effective in connection with the Exchange's computation of Net Capital unless at least the following conditions are met:

(1) The Will must contain provisions specifically authorizing the personal representative of the deceased partner either to continue the deceased's capital interest in the firm as limited capital, or otherwise to subordinate the estate's claims against the firm to the claims of creditors. Moreover, unless a change in the personnel of the successor firm is to terminate such authority, the Will must provide that the capital can be continued at the risk of the business of the continuing or successor firm despite changes in personnel in that firm.

(2) The period prescribed by law within which creditors of the decedent are required to file their claims against the estate must have expired.

(3) The Exchange must be furnished with affidavits setting forth the financial status of the decedent's estate.

(4) The Exchange must be furnished with a satisfactory opinion of counsel to the estate, to the effect that (A) the personal representative is duly authorized to become a partner in the firm or otherwise to subordinate the deceased partner's capital interest, (B) that there is no State tax lien on the decedent's interest, (C) that the decedent's interest is at the risk of the business for a stated period, and (D) that any claim which any legatees or creditors of the decedent may have is subordinated in right of payment to the claims of all firm creditors arising during the stated period.

(5) The Exchange must be furnished with a release of the Federal Estate Tax lien or satisfactory evidence that such tax has been paid in full and that there are no further claims against the estate in connection therewith.

(6) The personal representative of the decedent must have taken appropriate action either to become a limited partner in the firm or to subordinate the capital interest of the deceased partner as indicated above.

III.

In view of the fact that many partners of member firms may be serving in the Armed Forces, with the possibility that receipt of any knowledge of death may be considerably delayed, it is suggested that member firms having partners in the Armed Services consider the inclusion of provisions in their partnership articles continuing such partner's capital interest at the risk of the business until official notice of death is received and for an adequate length of time thereafter. It may also be desirable to specify the effect of an official notice that a person is "missing", e. g., that for the purposes of the articles such a notice shall be deemed the equivalent of notice of death or, on the other hand, that such a "missing" notice shall not be deemed notice of death until confirmation of actual death is received.

IV.

In drafting partnership articles, it is suggested that consideration be given to the question of whether or not appropriate provisions should be included with respect to the disposition and status of a partner's capital interest upon his withdrawal from the firm (as distinguished from his death). It is desirable to specify when his capital is to be repaid to him and whether or not, until such payment, it is to remain at the risk of the business of the continuing or successor firm.

V.

It is recommended that member firms consult their own counsel with respect to the advisability of incorporating in their partnership articles provisions of the sort discussed in this Section. Any member firm which decides to adopt

such provisions should submit the proposed provisions, prior to execution, to the Division of Documents, Department of Member Firms. Such member firm will then be advised whether, upon the adoption of such provisions and in the event of the death of a partner, the Exchange will be in a position to consider his interest in the firm as part of its net capital for the specified period following his death.

Information regarding the procedure followed by the Exchange in connection with indicating the interest, if any, of a deceased partner in a member firm in the listing of member organizations in the "Member Organizations" Section of the Directory, Vol. 1, N. Y. S. E. Guide, may be obtained from the Office of the Secretary.

.19 Borrowings of cash and securities by members, partners and stockholders of member organizations for capital purposes.—All borrowings, regardless of size or description, and whether collateralized or not, of cash or securities, where the proceeds represent or will represent capital of an individual member or a member organization under Rule 325 [¶ 2325], should be reported promptly to the Exchange.

As a matter of policy, the Exchange requires that the documents which evidence these borrowings for capital purposes conform to certain standards and that copies be submitted to the Department of Member Firms before the cash or securities involved may qualify as capital acceptable for inclusion in the computation of net capital under Rule 325 [¶ 2325].

The character of the documents varies, depending upon whether the lender is an individual, a member of a national securities exchange, bank, estate, trust, corporation, partnership, etc.

Borrowings for capital purposes should be executed on a time basis of at least six months' duration or, preferably, for a longer period of time. Capital borrowings of shorter duration are not acceptable unless, due to excep-

tional circumstances, they have received the prior approval of the Exchange.

It is, therefore, important that borrowers of cash or securities for capital purposes communicate with the Department of Member Firms (Extension 229, 387 or 455) prior to the consummation of any such borrowing to be sure the terms of the arrangement will permit the borrowed funds to be considered as capital under Rule 325 [¶ 2325].

A change in the amount or in any of the terms of a borrowing should be reported promptly to the Department of Member Firms in order that the Exchange will at all times have a current record of the status of such borrowed capital.

With respect to borrowings by a member organization on a subordinated basis, where the proceeds are to be considered in the computation of net capital under Rule 325 [¶ 2325], see .20, below.

.20 Subordinated borrowings by member organizations.—All subordinated accounts and all subordinated borrowings by a member organization—whether of cash or securities or both—where the proceeds are to be considered in the computation of net capital under Rule 325 [¶ 2325] must receive prior approval of the Exchange. Such borrowings may be arranged with anyone acceptable to the Board of Governors and are subject to the following provisions:

(1) Subordinated borrowings of cash

(A) The lender may be paid interest not exceeding 8%.

(B) If the lender is

(i) a member of the family of one of the borrowing organization's general partners or holders of voting stock, or of a deceased general partner or holder of voting stock;

(ii) an estate of or trust established by or for one of the borrowing organization's general partners or holders of voting stock;

(iii) one of the borrowing organization's employees or the employee pension, retirement or profit-sharing plan of the borrowing organization; or

(iv) a limited partner or holder of non-voting stock of the borrowing organization

he may also share in organization profits to a reasonable extent.

(2) Subordinated borrowings of securities; subordination of equities in customers' accounts

(A) If the lender is a person listed in (1)(B) above, he may be paid interest not exceeding 8%. He may also share in organization profits to a reasonable extent.

(B) If the lender is anyone other than those listed in (1)(B) above

(i) the lender's major account shall have been with the borrowing organization for at least two years, unless the lender had not been a customer of any organization for two years.

(ii) the number of such borrowings by a member organization shall be reasonable in relation to the size of the organization, and the total dollar amount of such borrowings shall not constitute more than 25% of the total capital of the borrowing organization.

(iii) compensation for the loan or subordination of the account shall not exceed 4% on the value of the securities.

(3) Application of the borrowing member organization shall be filed with the Exchange together with application signed by the lender, in form prescribed by the Exchange, which shall contain at least the following information:

(A) name of the lender; (in the case of subordinated borrowings of securities or of subordination of

equities in accounts, identify the relationship of the lender to the organization or one of its general partners or holders of voting stock).

(B) amount of borrowing;

(C) effective date;

(D) expiration date;

(E) compensation for the subordinated loan or subordination of the account, and

(i) interest rate, if fixed, or

(ii) details as to how it is to be calculated if it is to be measured by profits of the firm or by any direct or indirect interest in the distribution of the profits of the corporation.

(4) At the time the application for approval to make a subordinated borrowing is submitted to the Exchange for posting, there should accompany such application:

(A) signed copy of the subordination agreement in form prescribed by the Exchange;

(B) opinion of counsel to the borrowing organization stating that the subordination agreement is binding and enforceable in accordance with its terms upon the lender,

(C) check of the applying member organization for $100 covering Exchange fee for consideration of the application. While the fee is payable at the time of posting, a member organization may request that the charge be placed on the regular quarterly statement from the Exchange.

(5) A statement of a proposed lender for approval to make a subordinated loan to a member organization is ordinarily not acted upon by the Board of Governors until after notice of the proposal has been posted on the Bulletin Board of the Exchange for a period of two weeks. Such notice is posted upon submission, in proper form, of all required papers in connection with the proposal.

(6) The minimum time basis for a subordinated loan by a member organization shall ordinarily be at least one year, except that (A) in the case of a member firm, if the partnership agreement provides that limited partners may withdraw their capital contributions upon written notice of 90 days or less, and (B) in the case of a member corporation, the Certificate of Incorporation authorizes the redemption of the non-voting stock upon written notice of 90 days or less, provision may be made for payment in full of principal and interest prior to the expiration of the loan 90 days after written demand.

.30 Disclosure of subordinated borrowings in financial statements to customers.—Subordinated liabilities of member organizations shall be disclosed in the body of condensed financial statements issued to customers and such disclosure shall not be made solely by means of footnotes to such statements.

The subordinated liabilities may be shown in a separate section on the liability side of the statement following current liabilities and preceding net worth or capital or may be shown, for example, as follows:

*Subordinated Liabilities and Capital:

Liabilities subordinated to claims of general creditors __ $________

Capital (net worth or other acceptable title) __________ ________ ________

*If desired, this caption may be eliminated.

If any subordinated liability is covered by an agreement which will expire within a short time and which will not be renewed, the time of expiration of such agreement should be clearly shown.

(*See Rule* 419 [¶ 2419] *for requirements re financial statements to customers.*)

IN THE

United States District Court

FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

No. 70 C 1010 [71 C 1387]

JOHN H. BEEBE, JR., *et al.*,
Plaintiffs,

v.

McDONNELL & CO., INC.,
Defendant

LEONARD L. GREENE,
Plaintiff,

v.

McDONNELL & CO., INC., *et al.*,
Defendants.

Findings

1. Plaintiff, Thomas M. Terrill, is a citizen of Illinois and a resident of the Northern District of Illinois. Defendant, New York Stock Exchange, Inc., is a New York corporation having its principal place of business in New York. This action is brought under Sections 6 and 10 (b) of the Securities Exchange Act of 1934 pursuant to Section 27 of that Act.

2. Plaintiff Thomas M. Terrill first purchased non-voting common shares of McDonnell & Co., Incorporated, a member organization of defendant New York Stock Exchange in 1964 or 1965. By 1968 he was a Vice President of that firm and the highest level officer in the Chicago office.

He supervised 40-50 professional employees and communicated with the New York office of McDonnell & Co. as often as 15-18 times per day.

3. In the spring of 1968, like many other firms in the industry, McDonnell & Co. encountered "backoffice" problems because of an increasing volume of business, and was placed on restrictions by defendant New York Stock Exchange. These restrictions were designed to curb the volume of business. As a Vice President of McDonnell & Co. and the head of its Chicago office, plaintiff Terrill was aware of these restrictions.

4. After about one month of operation under these restrictions, McDonnell & Co. reduced its back office problems and the New York Stock Exchange lifted the restrictions. McDonnell & Co. continued to take active steps to improve its back office operations throughout the year 1968. Plaintiff Terrill was aware of those efforts also.

5. In October or November, 1968, plaintiff Terrill purchased 400 additional common shares in McDonnell & Co., of which 100 were voting shares. Later, in March, because of plaintiff Terrill's purchase of voting shares, he was required by the constitution and rules of the New York Stock Exchange to be approved as an allied member of the Exchange. Plaintiff Terrill considered it an honor and a recognition to be permitted to acquire stock, particularly voting stock, in McDonnell & Co., and to become an allied member of the New York Stock Exchange.

6. During the trial of this case, plaintiff Terrill introduced no evidence indicating that defendant New York Stock Exchange failed to enforce its rules and the securities laws or made any false or misleading statement or omission in connection with plaintiff Terrill's purchase of McDonnell & Co. common stock. Nor was there any evidence indicating that defendant New York Stock Exchange failed to perform any act within its powers and thereby caused plaintiff Terrill to suffer any damages in connection with his purchase of McDonnell & Co. common stock.

7. At the close of plaintiff's case in chief defendant New York Stock Exchange filed two motions. The first was a Rule 43 (c) Motion to Strike the evidence which had been admitted subject to connection up or other objection insofar as defendant New York Stock Exchange was concerned. The second was a Rule 41(b) Motion to Dismiss.

8. There are two reasons why it is not necessary for this Court to pass upon defendant New York Stock Exchange's Rule 43 (c) Motion to Strike:

(a) Essentially the same considerations which would render evidence inadmissible as to defendant New York Stock Exchange would also deprive that evidence of probative force with respect to that defendant;

(b) The disposition of defendant New York Stock Exchange's Rule 41 (b) Motion to Dismiss renders the Rule 43 (c) Motion to Strike moot.

Conclusions

1. This Court has jurisdiction of the parties and the subject matter herein.

2. Plaintiff Terrill has failed to establish a prima facie case in support of any of the allegations of his Complaint against defendant New York Stock Exchange.

3. The New York Stock Exchange is a person who was not a party to the purchase and sale transaction by which plaintiff Terrill acquired his stock. Furthermore, the Exchange's conduct consisted solely of inaction. It therefore can have no liability to plaintiff under Rule 10 b-5.

4. Count IX and X of the Complaint are dismissed pursuant to Rule 41 (b).

WILLIAM J. LYNCH

JUDGE, UNITED STATES DISTRICT COURT

Dated: Sept. 1, 1972

UNITED STATES COURT OF APPEALS

SECOND CIRCUIT

- x

MARGARET MARY McDONNELL MURPHY,

Plaintiff,

-against-

McDONNELL & CO. INCORPORATED and THE NEW YORK STOCK EXCHANGE by ROBERT W. HAACK, President,

Defendants.

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AFFIDAVIT OF SERVICE

ANNA M. McDONNELL, individually, as Executrix of the Estate of James F. McDonnell, and as Trustee under the Will of James F. McDonnell, and JAMES F. McDONNELL, JR., individually and as TRUSTEE under the Will of James F. McDonnell,

Plaintiffs,

-against-

THE NEW YORK STOCK EXCHANGE by ROBERT W. HAACK, THE NEW YORK STOCK EXCHANGE, INC., THE AMERICAN STOCK EXCHANGE by H. VERNON LEE, JR., Secretary and McDONNELL & CO., INC.,

Defendants.

- x

STATE OF NEW YORK)
: ss.:
COUNTY OF NEW YORK)

NED B. BERTULFO, being duly sworn, deposes and says:

I am over the age of 18 years and am not a party to this Action.

On November 8, 1976, I served two copies of the within brief on the attorneys listed below by depositing true copies thereof, securely enclosed in post-paid wrappers addressed to

each of such attorneys at their respective addresses in a mailbox maintained by the government of the United States at One Chase Manhattan Plaza, New York, New York.

Lord Day & Lord
25 Broadway
New York, N.Y.

Davis & Cox
1 State Street Plaza
New York, N.Y.

Proskauer Rose Goetz & Mendelsohn
300 Park Avenue
New York, N.Y.

Neil B. Bertuglio

Sworn to before me this

8th day of November, 1976.

Carlos Daniel Negron

CARLOS DANIEL NEGRON
NOTARY PUBLIC, State of New York
No. 24-4630273
Qualified in Kings County
Certificate Filed in New York County
Commission Expires March 30, 1978